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2558
No. 12074

United States
Court of Appeals
for the Ninth Circuit

RICE GROWERS ASSOCIATION OF
CALIFORNIA, a corporation,

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE, a Corpora-
tion, Owner of the Steamship "Frej",

Appellee.

Apostles on Appeal

Appeal from the United States District Court
for the Northern District of California,
Southern Division

FILED

FEB - 4 1949

PAUL P. O'BRIEN,
CLERK

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF PROCTORS

GEORGE H. HAUERKEN,
HAUERKEN & ST. CLAIR,

535 Russ Building,
235 Montgomery Street,
San Francisco, California.

Attorneys for Rice Growers Association of
California, Damage Claimant and Appel-
lant.

GRAHAM & MORSE,
310 Sansome Street,
San Francisco, California.

Attorneys for Petitioner and Appellee.

take said voyage, and the owner of said vessel had [2] exercised due diligence to make said vessel in all respects seaworthy, as hereinbefore set forth.

V.

That while said vessel was proceeding on said voyage between the port of San Francisco, California, and the port of Havana, Cuba, and after departing from Pier 45 at San Francisco, California, and while still in San Francisco Bay, a fire started in the boiler room of said vessel, thereafter spreading to the engine room and the No. 3 cargo compartments, and notwithstanding the efforts of the officers and crew of said vessel to extinguish said fire, the same continued to burn until about 5:00 a.m. on the morning of May 7, 1947. That upon the fire being extinguished the vessel was thereafter towed to Pier 45, and thereafter the damaged as well as the sound cargo was discharged and every effort made to preserve and protect the said cargo. That during the occurrence of said fire, the said vessel received assistance from tugs, fire boats and the U. S. Coast Guard, which assistance was rendered in aid of extinguishing the fire and towing the said vessel to Southampton Shoals, San Francisco Bay, where she was beached. That as a direct result of said fire, the said vessel became in an inoperable condition. That at the Port of San Francisco, California, as a direct and necessary result of said fire, it became and is necessary to effect substantial repairs to said steamship Frej in order to place said vessel in an operable and seaworthy condition. That

the cost of effecting said repairs to said vessel will be in excess of \$150,000, and the time required to effect said repairs will require not less than 58 calendar days. That the voyage of said vessel terminated in San Francisco, California, on May 8, 1947.

That attached hereto, marked Exhibit A, and incorporated [3] for all intents and purposes as though herein set forth in haec verba, is set forth a true copy of the bill of lading covering the receipt, loading, transportation and discharge of the cargo aboard the said vessel at the time of departure from San Francisco, California. That in and by Article 4 of the bills of lading covering the cargo aboard said vessel, it is provided in part:

“In any situation whatsoever and wheresoever occurring and whether existing or anticipated before commencement of or during the voyage which in the judgment of the carrier or the master is likely to give rise to risk of . . . detention, damage, delay or disadvantage to or loss of the ship . . . for any reason to commence or proceed on or continue the voyage . . . the carrier or the master, whether or not proceeding toward or entering, or attempting to enter the port of discharge . . . may discharge the goods at a depot, lazaretto, craft or other place . . . or the carrier or the master may discharge or forward the goods by any means, rail, water, land or air, at the risk and expense of the goods. The carrier or the master is not required to give notice of discharge of the goods or the forwarding thereof

as herein provided. When the goods are discharged from the ship as herein provided, they shall be at their own risk and expense. Such discharge shall constitute complete delivery and performance under this contract, and the carrier shall be free from any further responsibility. . . .”

That acting under the authority granted by the bill of lading clause above quoted, the master of the SS Frej did on June 19, 1947, notify all owners of cargo which had been aboard said vessel at the time of the commencement of said voyage that the voyage had terminated and had been abandoned and that the cargo was at the risk and expense of cargo and its owners at San Francisco, California.

VI.

That Rice Growers Association of California, a corporation, heretofore, to-wit, on the 6th day of June, 1947, did file a libel in admiralty in the District Court of the United States, Northern District of California, Southern Division, against the Steamship Frej, her engines, boilers, boats, tackle, apparel [4] and furniture, etc., and against the Rederiaktiebolaget Frode, a corporation, your petitioner herein, as owner of said vessel, in which cause said libelants assert that by written assignment they became the owner of the damaged and destroyed cases and/or sacks of rice, more particularly set forth in said libel, and seek to recover the sum of \$465,990, together with interest thereon and costs, the alleged damages which said libelants claim to have sustained by

reason of said fire. That upon process issued by said Court in said cause, your petitioner has been cited to appear in said court and to answer said libel. That said cause is now pending in said Court and is numbered 24958-G in admiralty in said Court. That the name of the proctors for said libelant is George H. Hauerken and Hauerken, Ames and St. Clair and the address of said proctors is 235 Montgomery Street, San Francisco, California.

That a libel has been filed in this Court by Jakko Olavi Eriksson against the Steamship Frej, etc., and against Rederiaktiebolaget Frode, a corporation, respondents, to recover alleged damages, wages, etc., in amount of \$6353.37 said to have resulted during said voyage, said cause being numbered 24978-R of the docketed admiralty causes in this Court; that a libel has been filed in this Court by Einer Hamalainen against the Steamship Frej, etc., and against Rederiaktiebolaget Frode, a corporation, respondents, to recover alleged damages, wages, etc., in amount of \$2,483.77 said to have resulted during said voyage, said cause being numbered 24979-H of the docketed admiralty causes in this Court; that Joseph B. McKeon, Esq., proctor in admiralty, represents certain salvage claimants against said vessel. [5]

VII.

Your petitioner alleges further that there are certain other claims which may be asserted against your petitioner or said vessel for alleged salvage

services rendered to said vessel during and following said fire as well as for alleged damage of cargo due to said fire, the exact amount and number of said claims being unknown to your petitioner.

VIII.

Petitioner alleges upon information and belief that there are no liens upon said steamship Frej prior or paramount to any liens which may have accrued by reason of the matters aforesaid, and that the amount of the alleged claim in the action which has been filed against said vessel and against your petitioner and of the additional claims which may be asserted against said vessel and your petitioner, as hereinbefore set forth, is or may be in excess of the sum of \$450,000.00, and exceeds the amount and value of the interest of your petitioner in said steamship, together with her freight pending at the end of said voyage, which terminated at the port of San Francisco, California, on or about the 8th day of May, 1947. That upon information and belief the value of your petitioner's interest in said steamship Frej and the value of your petitioner's interest in the freight pending at the end of said voyage on said 8th day of May, 1947, did not and does not exceed the sum of \$176,500.

IX.

That your petitioner desires to contest its liability and the liability of said steamship Frej for the injuries, losses, and damages, whether to persons or to property, caused, occasioned or incurred

upon said voyage, and particularly any loss and damage incurred by the owners or underwriters of the cargo aboard the [6] SS Frej, or other persons interested therein, and your petitioner hereby also claims the benefit of limitation of liability as provided in Sections 182, 183, 183b, 183c, 184, 185, 186, 187, 188 and 189 of the United States Code (being Sections 4282 to 4289, inclusive, of the Revised Statutes of the United States, as amended), and also hereby claims the benefit of any and all Acts of the Congress of the United States exonerating a shipowner from liability or granting a shipowner a limitation of liability for injuries, losses and damages, as are herein alleged, set forth or referred to, and your petitioner is now ready, able and willing, and hereby offers to give its stipulation or stipulations, with sufficient sureties, conditioned for the payment into this Court by your petitioner, if required, of the value of your petitioner's interest in said steamship Frej, together with her freight pending at the end of said voyage, if any was pending; such payment to be made whenever the same shall be ordered herein.

X.

While not in any way admitting that your petitioner is under any liability for the losses and damages occurring as aforesaid, and your petitioner hereby claiming and reserving the right to contest in this or any other Court any liability therefor, either personal or of said steamship Frej, your petitioner claims that it is entitled to have

limited its liability, if any, in the premises, to the amount or value of its interest as aforesaid in the said steamship Frej and freight pending, if any, at the end of said voyage.

XI.

That all and singular the premises are true and within the admiralty and maritime jurisdiction of the United States and of this Honorable Court. [7]

Wherefore, your petitioner prays that this Honorable Court order due appraisement to be had of the interest of your petitioner in said steamship Frej, her engines, etc., as the same were at the end of said voyage, and due appraisement of the interest of your petitioner in the amount of the freight pending, if any, at the close of said voyage; that this Honorable Court do make an order for the payment of said appraised value into the Court or for the giving of a stipulation with sureties for the payment thereof into the Court whenever the same shall be ordered, with interest, and upon compliance with said order this Honorable Court do issue a monition against said Rice Growers Association of California, a corporation, Jakko Olavi Eriksson, Einar Hamalainen, and all other persons claiming damages of your petitioner or against the said steamship Frej by reason of injuries to any persons, or of loss, damage or injury to property occurring or arising upon said voyage or resulting from said fire, citing them and each of them to appear before this Court and make due proof of their respective claims at or before a time

to be made in said writ, according to law and the rules and practice of this Court; and that this Honorable Court also, by an order or otherwise, restrain the prosecution of any or all suit or suits, action or actions, libel or libels, or legal proceedings of any manner or description, except in the present proceedings, against your petitioner or the steamship Frej, her engines, etc., in respect of the losses or damages claimed by reason of said fire and any and all claims occurring or arising upon said voyage of said steamship Frej; and that said steamship Frej may be released and discharged from arrest in the cause now pending as hereinbefore set forth, and in any other cause which may hereafter be commenced by reason of any claim arising out [8] or said fire or during said voyage, and that this Honorable Court decree that neither your petitioner nor the said steamship Frej is liable to any extent for any loss, damage or injury arising out of said fire or during said voyage, but if the Court should adjudge that they, or either of them, are liable to any extent therefor, then that such liability be limited to the amount and value of your petitioner's interest in said steamship Frej and her freight pending, if any, at the close of said voyage as aforesaid, and as such values may be determined by the appraisement of such interests, as hereinbefore prayed; and that the moneys paid or secured to be paid into Court as aforesaid be divided pro rata among the several claimants in proportion to the amount of their respective claims, duly approved and confirmed, saving to all

parties any priority to which they may be entitled legally; and that your petitioner may have such other and further relief as shall be deemed meet in the premises.

GRAHAM & MORSE,
Proctors for Petitioner.

State of California,

City and County of San Francisco—ss.

Clarence G. Morse, being first duly sworn, deposes and says:

That he is of counsel for the petitioner herein, Rederiaktiebolaget Frode, a corporation; that he has read the foregoing Petition and knows the contents thereof, and that the same is true, to the best of his own knowledge, except as to those matters therein stated to be alleged upon information and belief, and as to those matters he believes it to be true; the sources of his information and the grounds for his belief as to the [9] matters therein stated to have been alleged upon information and belief are statements and records contained in your affiant's office. The reason this verification is not made by an officer of the petitioning corporation is that none of the officers of the corporation is within the county or district within which your affiant has his offices.

CLARENCE G. MORSE.

Subscribed and sworn to before me this 24th day of July, 947.

[Seal] /s/ EMMA L. MacHUGH,
Notary Public in and for the City and County of
San Francisco, State of California.

My Commission Expires Jan. 15, 1948.

(Copy of Bill of Lading.)

[Endorsed]: Filed July 25, 1947. [10]

[Title of District Court and Cause.]

STIPULATION RE AMOUNT OF AD IN-
TERIM STIPULATION OF VALUE PEND-
ING APPRAISEMENT

It Is Hereby Stipulated by and between Rederiaktiebolaget Frode, a corporation, petitioner herein, Rice Growers Association of California, a corporation, Derby Sharp Quinby & Tweedt, representing certain cargo interest, and Joseph B. McKeon, Esq., proctor in admiralty representing certain salvage claimants of the Swedish steamship Frej, that pending the appraisement of the value of the interest of the said petitioner in the steamship Frej, her engines, etc., at the end of the voyage of said vessel during which said fire occurred, and the value of said petitioner's interest in and to the pending freight, if any, for said voyage, upon the petitioner giving a stipulation with the petitioner, Rederiaktiebolaget Frode, a corporation, as prin-

cipal, and an approved corporate surety as surety for the payment of the sum of \$290,250.00 into court, without interest on said sum either before or after [11] judgment, whenever the same shall be ordered, or upon petitioner depositing in this matter the sum of \$290,250.00 lawful money of the United States with the Clerk of the above-entitled Court, in lieu of giving a stipulation in said amount as above provided, such further proceedings may be taken in said limitation proceedings according to the course and practice of the above-entitled court and the rules and laws governing the same, as if said stipulation had been filed pursuant to a due appraisement of said vessel and pending freight.

It Is Further Stipulated that when the appraisement of said vessel and freight pending shall be completed and the appraised value of said petitioner's interest in said vessel and freight at said time has been duly fixed by order of the above-entitled court, the said stipulation of \$290,250.00, or the cash deposit of \$290,250.00, shall thereupon be reduced or increased to the amount of the appraised valuation of said petitioner's interest in said vessel and freight with interest thereon at the rate of six per cent per annum, and costs from the date of said stipulation for \$290,250.00 or from

the date of depositing said cash deposit, as the case may be.

Dated: July 30, 1947.

/s/ GRAHAM & MORSE,

Proctors for Rederiaktiebolaget Frode, Petitioners.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN, AMES & ST.

CLAIR,

Proctors for Rice Growers Association of California, a Corporation.

/s/ DERBY, SHARP, QUINBY &
TWEEDT,

Proctors for Certain Cargo
Interests.

/s/ JOSEPH B. McKEON,

/s/ WRIGHT & McKEON,

Proctors for Certain Salvage
Claimants.

[Endorsed]: Filed Aug. 1, 1947. [12]

[Title of District Court and Cause.]

AD INTERIM STIPULATION FOR VALUE
PENDING APPRAISEMENT

Whereas a Petition Was Filed Herein on the 25th day of July, 1947, by Rederiaktiebolaget Frode, a corporation, owner of the SS Frej, her engines, etc., praying for exoneration from, or limitation of its liability for any and all claims, injuries, losses or damages, occasioned or incurred upon

the voyage of said SS Frej, which voyage is stated in said petition to have ended at the port of San Francisco, California, on the 8th day of May, 1947, particularly any and all loss or damage arising out of the fire aboard the SS Frej which occurred in San Francisco Bay, California, on or about the 6th day of May, 1947.

And Whereas, an order of appraisement has been entered herein ;

And Whereas, a "Stipulation re Amount of Ad Interim Stipulation of Value Pending Appraisement" has been filed herein, fixing the Ad Interim Stipulation to be filed herein in the amount of \$290,-250.00, without interest on said sum either before or after judgment.

Now Therefore, It Is Stipulated and Agreed, for the benefit of whom it may concern, that the stipulators undersigned are, and each of them is, bound in the sum of \$290,250.00 in a lawful money of the United States of America, without interest on said sum either [13] before or after judgment.

The condition of this stipulation is such that if the petitioner herein and Royal Indemnity Co., a corporation organized and existing under the laws of the State of New York, and duly qualified under and by virtue of the laws of the State of California to act as a corporate surety, the stipulators undersigned, shall abide by all orders of the court, interlocutory or final, and pay into Court the above sum of Two Hundred Ninety Thousand Two Hundred Fifty Dollars (\$290,250.00), without interest on said sum either before or after judgment, when-

ever ordered by this Court or by any appellate court, if an appeal intervene, then this stipulation to be void; otherwise to remain in full force and virtue.

This stipulation shall be deemed and construed to contain the "express agreement" for summary judgment, and execution thereon, mentioned in Rule 19 of the District Court.

Dated: San Francisco, California, July 25, 1947.

REDERIAKTIEBOLAGET

FRODE,

A Corporation.

By J. H. WINCHESTER & CO.,

INC.,

By L. J. CLOUD,

Mgr. Chartering & Ship Sales.

[Seal]

ROYAL INDEMNITY

COMPANY,

By JAMES D. SIMPSON,

Attorney in Fact.

State of California,

City and County of San Francisco—ss.

On this 1st day of August in the year 1947 before me, Eugene P. Jones, a Notary Public in and for the County and State aforesaid, personally appeared James D. Simpson, known to me to be the person whose name is subscribed to the within instrument and known to me to be the Attorney in Fact of Royal Indemnity Company and acknowledged to me that he subscribed the name of the said Com-

pany thereto as principal, and his own name as Attorney in Fact. [14]

[Seal]

EUGENE P. JONES,

Notary Public in and for Said
County and State.

My Commission Expires December 28, 1947.

State of California,

City and County of San Francisco—ss.

On this 1st day of August in the year One Thousand Nine Hundred and Forty Seven, before me, Emma L. MacHugh, a Notary Public, in and for the City and County of San Francisco, State of California, residing therein duly commissioned and sworn personally appeared L. H. Cloud, known to me to be the Manager, Chartering & Ship Sales of the corporation described in and that executed the within instrument and also known to me to be the person who executed the within instrument on behalf of the corporation therein named and acknowledged to me that such corporation executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal, at my office in the City and County of San Francisco, the day and year in this certificate first above written.

[Seal]

EMMA L. MacHUGH,

Notary Public in and for the City and County of
San Francisco, State of California.

(Power of Attorney.)

[Endorsed]: Filed Aug. 1, 1947. [15]

[Title of District Court and Cause.]

ORDER FOR AD INTERIM STIPULATION

Rederiaktiebolaget Frode, a corporation, having filed a petition for the limitation of petitioner's liability as sole owner of the steamship Frej and having prayed for an appraisal of the value of petitioner's interest in the vessel and her pending freight, if any, and for leave to file a stipulation for the amount of its appraised value or an ad interim stipulation pending the appraisal of petitioner's interest in said vessel and her pending freight, if any, by a Commissioner to be appointed by the Court, and a "Stipulation Re Amount of Ad Interim Stipulation of Value Pending Appraisement" having been filed herein providing for an Ad Interim Stipulation in the sum of \$290,250.00 without interest on said sum before or after judgment.

Now, on motion of Graham & Morse, proctors for petitioners, it is [16]

Ordered, pursuant to said "Stipulation re Amount of Ad Interim Stipulation of Value Pending Appraisement," that the petitioner file herein an ad interim stipulation in the sum of \$290,250.00, without interest thereon before or after judgment, with surety according to the rules and practice of this Court; and it is further

Ordered that any party may apply to have the amount in said stipulation increased or diminished as the case may be, to the amount of the appraised valuation of said petitioner's interest in said vessel and freight, with interest thereon at the rate of

six per cent per annum and costs from the date of said stipulation for \$290,250.00 first above mentioned, on the filing of the report of the Commissioner appointed to appraise the amount or value of petitioner's interest in said vessel and pending freight, if any, or on the ultimate determination of the Court on exceptions to the Commissioner's report.

Dated: August 4, 1947.

LOUIS E. GOODMAN,
United States District Judge.

Approved as to Form:

.....,
Proctors for Rice Growers
Association.

.....,
Proctors for Certain Cargo
Interests.

.....,
Proctors for Certain
Salvage Claimants.

[Endorsed]: Filed Aug. 4, 1947. [17]

[Title of District Court and Cause.]

ORDER OF REFERENCE FOR
APPRAISEMENT

Present: Honorable Louis E. Goodman.

It appearing to this Court that a petition for limitation of liability has heretofore been filed herein

by the above named petitioner, and application having been made for an order appointing an appraiser to appraise the value of said petitioner's interest in the SS Frej, her engines, boilers, boats, tackle, apparel, furniture and appurtenances, immediately after the fire mentioned and said petitioner's interest in the freight of said steamship pending, if any, at the close of the voyage mentioned in said petition for limitation of liability, and good cause appearing therefor, upon motion of Graham & Morse, proctors for petitioner, it is hereby

Ordered that in pursuance of the Acts of Congress in such case made and provided, and of the rules and practice of this Court [18] in proceedings for the limitation of liability, the above matter be, and the same is, hereby referred to Francis St. J. Fox, United States Commissioner for the Northern District of California, to make due appraisement of the value of the petitioner's interest in said steamship Frej, her engines, boilers, tackle, etc., immediately after said fire, and her pending freight, if any, (1) at the end of the voyage stated in said petition, to wit, on the 8th day of May, 1947; (2) as of the date of this order; and (3) as of the date of the arrival of the steamship Frej at discharging dock in Havana, Cuba; and that he report the same with the testimony to be taken by him, and his opinion thereon to this Court with all convenient speed; and that notice of the proceedings before the said Commissioner be given

to the persons who have presented claims or brought suits, or to their proctors or attorneys.

Dated: August 4th, 1947.

LOUIS E. GOODMAN,
United States District Judge.
GRAHAM & MORSE,
Proctors for Petitioner.

Approved as to Form.

/s/ GEORGE H. HAUERKEN,
/s/ HAUERKEN, AMES & ST.
CLAIR,
Proctors for Rice Growers
Association of California.
/s/ DERBY SHARP, QUINBY &
TWEEDT,
Proctors for Certain Cargo
Interests.

/s/ JOSEPH B. McKEON,
/s/ WRIGHT & McKEON,
Proctors for Certain
Salvage Claimants.

[Endorsed]: Filed Aug. 4, 1947. [19]

[Title of District Court and Cause.]

AMENDED ORDER FOR MONITION, FIXING
TIME AND PLACE FOR FILING CLAIMS
AND RESTRAINING ACTIONS

This matter having come on for hearing upon the application of Rederiaktiebolaget Frode, a cor-

poration, the above named petitioner, for an order for monition, fixing time and place for filing claims and restraining actions in the above entitled matter and it appearing that said petitioner did heretofore, to wit, on the 25th day of July, 1947, file herein a petition, as owner of the SS Frej, her engines, etc., praying for exoneration from or limitation of its damages, occasioned or incurred upon a voyage of said steamship Frej, which it is alleged in said petition ended at the Port of San Francisco, California, on the 8th day of May, 1947, and particularly any and all loss or damage arising out of the fire aboard said SS Frej, which occurred in San Francisco on or about the 6th day of May, 1947.

And it further appearing that a libel has been filed in this Court by Rice Growers Association of California, a corporation, against the SS Frej, her engines, boilers, boats, tackle, apparel, furniture, etc., and against Rederiaktiebolaget Frode, a corporation, respondents, to recover alleged damages in the sum of \$365,990.00 said to have resulted from said fire, and an amended libel to recover additional [20] alleged damages in the sum of \$100,000.00, said cause being No. 24958-G of the docketed admiralty causes in this Court;

And it further appearing that a libel has been filed in this Court by Jakko Olavi Eriksson against the Steamship Frej, her engines, boilers, etc., and against Rederiaktiebolaget Frode, a corporation, respondents, to recover alleged damages, wages, etc., in the amount of \$6353.37, said to have resulted during said voyage, said cause being numbered

24978-R of the docketed admiralty causes in this Court;

And it further appearing that a libel has been filed in this Court by Einar Hamalainen against the Steamship Frej, her engines, boilers, etc., and against Rederiaktiebolaget Frode, a corporation, respondents, to recover alleged damages, wages, etc., in amount of \$2483.77, said to have resulted during said voyage, said cause being numbered 24979-H of the docketed admiralty causes in this Court;

And it further appearing that Joseph B. McKeon, Esq., proctor in admiralty, represents certain salvage claimants against said vessel;

And an order having been entered herein for an ad interim stipulation and for the appraisement of the value of said petitioner's interest in the steamship Frej, her engines, boilers, boats, tackle, apparel, furniture and appurtenances at the end of the voyage mentioned in said petition for limitation of liability and also the value of said petitioner's interest in the freight, if any, of said steamship pending for said voyage;

And it further appearing that said Petitioner has filed with the Clerk of this Court an ad interim stipulation in the sum of \$290,250 with Royal Indemnity Company as surety, which stipulation is filed pursuant to "stipulation re amount of ad interim stipulation of value pending appraisement" on file herein and said stipulation been duly approved by this Court;

Now, Therefore, on motion of Messrs. Graham & Morse, proctors for said petitioner, It Is Hereby

Ordered that a monition issue out of and under the seal of this Court against all persons claiming for any and all loss, destruction, damage or injury, whether to persons or property, caused by or resulting from the fire aboard the SS Frej [21] which occurred in San Francisco Bay on or about the 6th day of May, 1947, and all persons claiming damages for any loss, destruction, damage or injury, whether to persons or property, arising out of or incurred on the voyage of said SS Frej during which said fire occurred, which said voyage is alleged in said petition to have commenced at San Francisco, California, on or about the 6th day of May, 1947, and to have ended at the Port of San Francisco on the 8th day of May, 1947, citing them, and each of them, to appear before the Court and make due proof of their respective claims on or before the 6th day of October, 1947, at ten o'clock a.m. of that day, and Francis St. J. Fox, United States Commissioner for the Northern District of California, is hereby appointed Commissioner before whom proof of all claims, which shall be presented pursuant to said monition, shall be made, subject to the right of any person or persons to controvert the same;

And It Is Further Ordered that public notice of said monition be given by publication in the Recorder, a newspaper published in the City and County of San Francisco, State of California, in the manner and for the time provided by law and by the rules of this Court, and that a copy of said notice be served upon all parties or their proctors,

who have filed libels, commenced actions, or made claims against said SS Frej, or against said petitioner, by reason of any loss, destruction, damage, or injury, alleged to have been incurred or sustained as a result of said fire or upon said voyage;

And It Is Further Ordered that the further prosecution of the aforesaid libel (first and third cause of action thereof only) by Rice Growers Association of California, libellant, against the SS Frej, her engines, boilers, boats, tackle, furniture, apparel, etc., and against the Rederiaktiebolaget Frode, a corporation, respondents, numbered 24958-G in admiralty, and commencement or prosecution of any and all other suit or suits, action or actions, libel or libels, or legal proceedings of any manner or description, except in the present proceedings against Rederiaktiebolaget Frode, petitioner herein, or against the SS Frej, her engines, boilers, boats, tackle, apparel, furniture and appurtenances in respect of any claim for loss, destruction, [22] damage or injury, by reason of said fire on or about said 6th day of May, 1947, aboard the SS Frej, or any claim occurring upon or arising out of said voyage of said SS Frej during which said fire occurred, which voyage is alleged in said petition to have commenced at San Francisco, California, on or about the 6th day of May, 1947, and to have ended at the Port of San Francisco on the 8th day of May, 1947, be, and the same are, and each of them is, hereby restrained;

And It Is Further Ordered that the service of this order as a restraining order be made within

this, the Northern District of California, in the usual manner, and in any other District of the United States by delivery by the Marshal of the United States for such district of a certified copy of this order to the person, or persons, to be restrained, or to their attorneys or proctors acting in their behalf.

This order does not restrain the further prosecution of any one or all of the following matters: (1) the libel of Jakko Olavi Ericksson against the steamship Frej, her engines, etc., being numbered 24978-R of the docketed admiralty causes in this Court; (2) the libel of Einar Hamalainen against the steamship Frej, her engines, etc., being numbered 24979-H of the docketed admiralty causes in this Court; and (3) the second cause of action as set forth in the libel, as amended, of Rice Growers Association of California, a corporation, against the steamship Frej, her engines, etc., being numbered 24958-G of the docketed admiralty causes in this Court; reserving, however, unto all parties the right at any time to apply to this Court for an order restraining the further prosecution of any one or all of the said three causes in this paragraph just mentioned.

Dated: August 20th, 1947.

LOUIS E. GOODMAN,
United States District Judge.

[Endorsed]: Filed Aug. 20, 1947. [23]

[Title of District Court and Cause.]

ANSWER OF RICE GROWERS ASSOCIATION
OF CALIFORNIA TO PETITION FOR LIM-
ITATION OF LIABILITY

Comes now claimant Rice Growers Association of California, a corporation, and files this, its answer to the Petition of Rederiaktiebolaget Frode, a corporation, for Exoneration from or Limitation of Liability, and answers, admits, denies and alleges as follows:

I.

Answering Article I of said Petition, claimant admits the allegations therein contained.

II.

Answering Article II of said Petition, claimant admits that the said Steamship "Frej" is a Swedish vessel and admits that said steamship was at all times herein referred to used and employed by Petitioner in the business of transporting cargo between the Port of San Francisco and the Port of Havana, Cuba, but except as herein expressly admitted, claimant, having no information or [24] belief on the subject sufficient to enable it to answer, denies each and every, all and singular, the allegations contained in Article II.

III.

Answering Article III of said petition, claimant denies generally and specifically, each and every, all and singular, the allegation therein contained.

IV.

Answering Article IV of said petition, claimant admits that on May 6th, 1947, the Steamship "Frej" sailed from the Port of San Francisco, California, bound on a voyage to the Port of Havana, Cuba, but except as herein expressly admitted, claimant denies generally and specifically, each and every, all and singular, the allegations therein contained.

V.

Answering Article V of said petition, claimant admits that while said vessel was proceeding on a voyage between the Port of San Francisco and the Port of Havana, Cuba, and while still in San Francisco Bay, a fire started in the boiler room of said vessel, thereafter spreading to the engine room and the No. 3 cargo compartments and that said fire continued to burn until about 5:00 a.m. on the morning of May 7, 1947; further, that upon the fire being extinguished, the vessel was thereafter towed to Pier 45, and thereafter the cargo was discharged; further, that during the occurrence of said fire, the said vessel received assistance from tugs, fireboats and the U. S. Coast Guard; but except as herein expressly admitted, denies generally and specifically, each and every, all and singular, the allegations therein contained.

VI.

Answering Article VI of said petition, claimant admits that it did on the 6th day of June, 1947, file a libel in Admiralty [25] in the District Court of

the United States, Northern District of California, Southern Division, against the Steamship "Frej," her engines, boilers, boats, tackle, apparel and furniture, etc., and against the Rederiaktiebolaget Frode, a corporation, as owner and operator of said vessel, in which cause claimant asserted that by written assignment and/or by written authority, claimant became authorized to file said libel; further, pursuant thereto and pursuant to the amendment to libel, claimant sought the total sum of Four Hundred Sixty-five Thousand Nine Hundred Ninety (\$465,990.00) Dollars; further, that pursuant to dismissal without prejudice of the second cause of action contained in the amendment to said libel, the demand was reduced to Three Hundred Seventy Thousand Nine Hundred Ninety (\$370,990.00) Dollars, together with interest thereon and costs, and the damages alleged in said libel and said amendment to said libel to be sustained by reason of said fire; further, that upon process issued by said court in said cause, petitioner was cited to appear in said court and to answer said libel; further, that said cause is now pending in said court and is No. 24958-G, in Admiralty, in said court; further, that the names of the proctors for claimant in said libel are George H. Hauerken and Hauerken, Ames & St. Clair, and the address of said proctors is 235 Montgomery Street, San Francisco 4, California.

Further answering Article VI of said petition, claimant admits that a libel has been filed in this

court by Jakko Olavi Eriksson against the Steamship "Frej," etc., and against Rederiaktiebolaget Frode, a corporation, to recover damages, wages, etc., in the amount of Six Thousand Three Hundred Fifty-three and 37/100 (\$6,353.37) Dollars, said to have resulted during said voyage, said cause being No. 24978-R of the docketed Admiralty causes in this court; further, that a libel has been filed in this court by Einar Hamalainen against the Steamship "Frej," etc., and against Rederiaktiebolaget Frode, a corporation, to recover [26] damages, etc., in the amount of Two Thousand Four Hundred Eighty-three and 77/100 (\$2,483.77) Dollars, said to have resulted during said voyage, said cause being No. 24979-H of the docketed Admiralty causes in this court; further, that The Shipowners and Merchants Tugboat Company, a corporation, and Shipowners & Merchants Towboat Co., Ltd., a corporation, have asserted a claim by the filing of a libel in this court under No. 25088-R in Admiralty and that Joseph B. McKeon, Esq., and Wright & McKeon are the proctors for said salvage claimants; but, except as herein expressly admitted, claimant denies generally and specifically, each and every, all and singular the allegations therein contained.

VII.

Answering Article VII of said petition, claimant admits the allegations therein contained.

VIII.

Answering Article VIII of said petition and the wording beginning with the word "petitioner" on

page 6, line 9, and ending with \$450,000” on page 6, line 16, claimant has no information or belief as to the matters therein alleged and basing its denial on such lack of information and belief, denies generally and specifically, each and every, all and singular, the allegations therein contained.

Further answering Article VIII of said petition and particularly the wording beginning with the word “and” on page 6, line 16, and ending with “\$176,500” on page 6, line 24, claimant denies generally and specifically, each and every, all and singular, the allegations therein contained.

IX.

Answering Article IX of said petition, claimant denies that petitioner is entitled to the benefit of limitation of liability as contended for and alleged in said Article IX and further denies that petitioner is entitled to the benefit of any [27] act of the Congress of the United States exonerating a ship owner from liability or granting a ship owner limitation of liability as alleged in Article IX, or otherwise, and further denies generally and specifically, each and every, all and singular, the allegations in said Article IX contained.

X.

Answering Article X of said petition, claimant denies generally and specifically, each and every, all and singular, the allegations therein contained.

XI.

Answering Article XI of said petition, damage claimant admits the allegations therein contained.

XII.

Further answering said petition, claimant alleges that the true facts are as follows:

(a) At all times herein mentioned, claimant was and now is a corporation organized and existing under and by virtue of the laws of the State of California.

(b) At all times herein mentioned, petitioner was and now is the owner and operator of the Steamship "Frej" which was and now is a general ship engaged in the common carriage of merchandise for hire between, amongst others, the Port of San Francisco, California, and the Port of Havana, Cuba.

(c) On or about April 29, 1947, claimant delivered to the said Steamship "Frej" and to petitioner, at the Port of San Francisco, certain shipments of rice in good order and condition, to be carried from said Port of San Francisco to the Port of Havana, Cuba, there to be delivered in like good order and condition as when shipped, to the order of claimant, arrival notice to be addressed to various consignees as hereinafter set forth, and that said shipments were made in consideration of an agreed freight in the total sum of One Hundred One Thousand Nine Hundred Seventy-seven [28] and 03/100 (\$101,977.03) Dollars, as hereinafter set forth, and in accordance with the terms of eighteen (18) bills of lading, as hereinafter set forth, then and there signed and delivered to claimant by the duly authorized agent and/or

representative of petitioner and of said Steamship "Frej".

The bills of lading numbers, the notify addressees, the description of each shipment and the freight paid on each shipment, are as follows:

B/L No.	Notify Addressee	Shipment	Freight
1	Hijos De Pio Ferra, S.A.....	6,000 cases) 7,000 sacks)	\$10,219.57
2	Hijos De Pio Ferra, S.A.....	8,000 cases	4,151.90
3	Hijos De Pio Ferra, S.A.....	14,000 sacks	14,211.79
4	Messrs. Aguilera, Manganon y Cia....	10,000 sacks	10,151.56
5	Messrs. Aguilera, Manganon y Cia....	1,000 sacks	1,016.06
6	Messrs. Aguilera, Manganon y Cia....	10,000 sacks	10,151.56
7	Messrs. Aguilera, Manganon y Cia....	10,000 sacks	10,151.56
8	Pinan Arexer y Cia, S-en-C.....	1,000 sacks	1,016.06
9	Pinan Arxer y Cia, S-en-C.....	2,000 cases	1,038.73
10	J. Perez, S. A.....	3,000 cases	1,557.59
11	J. Perez, S. A.....	3,000 sacks	3,046.17
12	F. Bonet-y-Cia, S-en-C	1,000 sacks	1,016.06
13	F. Bonet-y-Cia, S-en-C	1,000 sacks	1,016.06
14	Carvajal-y-Cia, S-en-C	8,000 cases	4,151.90
15	Carvajal-y-Cia, S-en-C	7,000 cases) 5,500 sacks)	9,215.85
16	Carvajal-y-Cia, S-en-C	13,500 sacks	13,704.26
17	Pelaez, Pirez, y Cia	6,000 cases	3,114.18
18	Pelaez, Pirez, y Cia	3,000 sacks	3,046.17

Thereafter, said Steamship "Frej" having on board said merchandise, sailed from the Port of San Francisco, en route to the Port of Havana, Cuba.

(d) While still in San Francisco Bay, and on May 6, 1947, [29] a fire started in the boiler-room of said vessel thereafter spreading to the engine-room and the No. 3 compartment. That the rice loaded in the No. 2 and No. 3 compartments was badly damaged and/or destroyed by fire, smoke

and water used to extinguish the fire. Thereafter, the entire cargo was discharged at San Francisco. Thereafter the cargo previously loaded in the Nos. 1, 4 and 5 compartments was reloaded in said vessel, having suffered some handling damage, and said vessel and the rice loaded in Nos. 1, 4 and 5 compartments are now proceeding to Havana, Cuba, to complete the voyage contracted for in said bills of lading. Some of the damaged rice discharged from No. 2 and 3 compartments was reconditioned, as much as reconditioning could be effected, and then sold, and some of said rice was sold in its condition as discharged from said vessel. That reconditioning charges, surveyors' fees, transportation and other expenses were incurred by claimant to minimize and fix the loss and/or damage aforesaid.

(e) A salvage claim of Fifty Thousand (\$50,000) Dollars has been made by The Shipowners and Merchants Tugboat Company, a corporation, and Shipowners and Merchants Towboat Co., Ltd., a corporation, and a libel has been filed in this court pursuant thereto under Proceeding No. 25008-R, in Admiralty, seeking recovery of the sum of Fifty Thousand (\$50,000) Dollars from the Steamship "Frej" and the cargo of rice described in Article XII(c) of this answer.

(f) Said fire was proximately caused by the design or neglect of petitioner in that

(1) The said vessel being unseaworthy at the time of her purchase by petitioner in March-April, 1947, owing to the large amount of free oil on

the tank tops immediately below the boilers and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the ship, petitioner took no steps at any time to eliminate this fire [30] hazard but petitioner sent said vessel on her said voyage in said condition, and

(2) Knowing the said vessel to be unseaworthy at the time of her purchase by petitioner in March-April, 1947, owing to a large amount of free oil on the tank tops immediately below the boilers, and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the ship, petitioner took no steps at any time to eliminate this fire hazard but petitioner sent said vessel on her said voyage in said condition, and

(3) Knowing the said vessel to be unseaworthy before and/or at the beginning of the voyage owing to a large amount of free oil on the tank tops immediately below the boilers, and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the ship, petitioner sent said vessel on her said voyage in said condition, and

(4) The said vessel being unseaworthy at the time of her said purchase due to insufficient fire-fighting equipment, petitioner took no steps at any

time to remedy this lack, but petitioner sent said vessel on her said voyage in said condition, and

(5) Knowing the said vessel to be unseaworthy at the time of her said purchase due to insufficient fire-fighting equipment, petitioner took no steps at any time to remedy this lack but petitioner sent said vessel on her said voyage in said condition, and

(6) Knowing the said vessel to be unseaworthy before and at the beginning of the voyage in that said vessel did not have on board and on duty competent engine-room officers and crew, [31] petitioner sent said vessel on her said voyage in said condition.

By reason of the premises, the fire from the starboard boiler was communicated to the oily fire-room bulkhead and/or the oily skin of the ship and/or to the free oil on the tank tops immediately below the starboard boiler and then to the free oil in the engine-room bilges, or having started, was not promptly extinguished.

(g) Many sacks and cases of rice originally loaded in No. 2 and 3 compartments were damaged and/or destroyed and the damaged rice retained and disposed of in San Francisco and Sacramento, California. The balance of the rice suffered some handling damage, the exact nature and extent of which is unknown to the claimant at this time. To the best information and belief of claimant, the loss and/or damage and/or expense as a result of said fire was and is:

38 *Rice Growers Association of California*

Rice damaged and/or destroyed by fire and/or smoke and/or water
and sold at San Francisco and Sacramento:

B/L No.	Notify Addressee	C.I.F. Value
1, 2, 3	Hijos De Pio Ferra, S. A.....	\$ 81,760.31
4, 5, 6, 7	Aguilera, Marganon y Cia.....	154,249.59
8, 9	Pinan, Arxer & Cia, S. en C.....	438.22
10, 11	J. Perez, S. A.....	19,333.11
12, 13	F. Bonet y Cia.....	158.34
14,15, 16	Carvajal y Cia, S. en C.....	114,429.10
17, 18	Pelaez, Pirez y Cia.....	42.47

\$370,411.14

Less salvage proceeds on the sale of said rice..... 129,191.26

\$241,219.88

The following expenses were incurred in reconditioning,
sale, survey, etc.:

California Dehydrating Co.—reconditioning.....	19,273.06
River Lines—Transportation to dehydrating plant.....	7,780.12
P. J. Seale & Associates—Commisison on sale of dam- aged rice	8,608.73
Genereaux & Hansen—Survey fee.....	100.00
Cost of cartons to repack.....	28.46
Department of Agriculture.....	318.70
Estimated Surveyors' fees.....	25,000.00

\$302,328.95

Estimated handling damages which cannot be ascertained
until the S.S. "Frej" arrives at Havana, Cuba, and the
cargo in Nos. 1, 4 and 5 compartments is discharged
and surveyed\$ 50,000.00

Total.....\$352,328.95

Claimant reserves the right to amend the claim
herein advanced at such time as the actual loss
and/or expense and/or damage is ascertained, this
not being possible at this time owing to the fact
that the S.S. "Frej" and her cargo have not yet
arrived at destination.

(h) Prior to the date hereof, and by written assignment, claimant became the owner of the damaged and destroyed cases and sacks of rice hereinabove mentioned with respect to all of the named addresses except Pinan, Arxer y Cia, S. en C., and is entitled to maintain the claim herein set forth.

On all shipments mentioned herein and including those in which Pinan, Arxer y Cia, S. en C., are the notify addressees, claimant has been authorized in writing to prosecute these claims.

(i) Claimant and/or the various notify addressees have performed all of the conditions precedent contained in the contract of carriage on their part to be performed. [33]

(j) By reason of the premises, claimant has sustained damage in the sum of **Three Hundred Fifty Two Thousand Three Hundred Twenty-eight and 95/100 (\$352,328.95) Dollars**, together with interest thereon at the rate of **Seven (7%) Percent per annum** from May 6, 1947, until paid.

XIII.

Further answering said petition, claimant alleges:

(a) Repeats and realleges as fully as though herein set forth again at length, each and every and all of the allegations contained in sub-paragraphs (a), (b), (c), (d), (h) and (i) of Article XII of this answer.

(b) Said S.S. "Frej" and petitioner, and each of them, carelessly and negligently mixed said shipments of rice on loading in San Francisco, Cali-

formia. That said shipments were separately marked and are of different grades and values. That the reasonable cost of re-piling and segregating said shipments according to mark and grade and value as when delivered to said S.S. "Frej" and petitioner, and each of them, would be and is Three Thousand Nine Hundred Thirty-five and 08/100 (\$3,935.08) Dollars. By reason of the premises, claimant has sustained damage in the sum of Three Thousand Nine Hundred Thirty-five and 08/100 (\$3,935.08) Dollars, together with interest at the rate of Seven (7%) Percent per annum from May 6, 1947, until paid.

Wherefore, claimant prays that the petition for exoneration from or limitation of liability of petition be denied; that this court will decree the payment by said petitioner to claimant of the sum of Three Hundred Fifty-six Thousand Two Hundred Sixty-four and 03/100 (\$356,264.03) Dollars, and all sums assessed against said cargo on all salvage claims against said cargo, including but not limited to the salvage claims referred to in Article XII(e) of this answer, together with interest and costs; and that claimant may have such other and further relief as may be just.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN, AMES &

ST. CLAIR,

Proctors for Libellant. [34]

State of California,
City and County of San Francisco—ss.

George H. Hauerken, being first duly sworn,
deposes and says:

That he is one of the proctors for the Rice Growers Association of California, claimant herein; and he has read the foregoing answer and knows the contents thereof. That the same is true of his own knowledge, except as to the matters therein stated to be alleged upon information and belief and as to those matters he believes it to be true.

The sources of his information and the grounds for his belief as to the matters therein stated to be alleged upon information and belief are statements and records contained in your affiant's office.

The reason this verification is not made by an officer of the claimant corporation is that none of the officers of said corporation are now within the County in which your affiant has his offices.

/s/ GEORGE H. HAUERKEN.

Subscribed and sworn to before me this 8th day
of September, 1947.

(Seal) ALFRED D. MARTIN,
Notary Public in and for the City and County of
San Francisco, State of California.

(Affidavit of Service by Mail.)

[Endorsed]: Filed Sept. 8, 1947.

[35]

At a Stated Term of the United States District
Court held in and for the Northern District of

California, Southern Division, at the United States Court Rooms, in the City and County of San Francisco, California, on the 6th day of October, 1947.

Present: The Honorable Louis E. Goodman, District Judge.

[Title of Cause.]

ORDER NOTING DEFAULTS

This Court having heretofore issued a monition against all persons claiming damages for any and all loss, destruction, damage or injury either to persons or property, caused by or resulting from the fire aboard the said S.S. "Frej" which occurred in San Francisco Bay, California, on or about the 6th day of May, 1947, or for any loss, destruction, damage or injury arising out of or incurred on the voyage of the said S.S. "Frej" during which said fire occurred, which said voyage is alleged in the petition on file herein to have commenced on or about the [36] 6th day of May, 1947, and to have ended in the Port of San Francisco on the 8th day of May, 1947, citing them and each of them to appear before this Court and make due proof of their respective claims on or before the 6th day of October, 1947, at ten o'clock a.m. of said day; and

It Appearing from the affidavit of publication on file herein that citation and notice of monition was duly published pursuant to the order of this Court in The Recorder, a newspaper published in the City and County of San Francisco, once each week until the return day of said monition, and that

the date of the first publication of said citation and notice of monition was August 21, 1947; and

It Further Appearing by the return filed herein by the United States Marshal for the Northern District of California that a copy of said monition and a copy of the order for monition were served more than thirty days prior to this date upon the Rice Growers Association of California, a corporation, the Shipowners & Merchants Tugboat Company, a corporation, and Shipowners & Merchants Towboat Company, Limited, a corporation, and that each of said corporations was at the time of the service of said monition and order for monition cited and admonished by the United States Marshal to appear before said Court and to file and make due proof of their respective claims before Francis St. J. Fox, United States Commissioner for the Northern District of California, at his office in the Post Office Building at 7th and Mission Streets, in the City and County of San Francisco, Northern District of California, on or about the 6th day of October, 1947, at ten o'clock a.m. of said day, otherwise they would be defaulted and debarred from participation in this suit; and [37]

It Further Appearing by the report of said Commissioner filed herein that the following claim has been presented to and filed with him, viz.:

Claim of Rice Growers Association of California, a corporation, for damages in the total sum of \$356,264.03, with interest and costs, filed by Messrs. Hauerken, Ames & St. Clair, proctors for said Rice Growers Association of California;

and that no other claim has been presented to or filed with said Commissioner; and

It Further Appearing that pursuant to stipulation of counsel, it has been ordered by this Court that the Shipowners & Merchants Tugboat Company, a corporation, and Shipowners & Merchants Towboat Company, Limited, a corporation, being represented herein by Messrs. Wright & McKeon, may have to and including the 16th day of October, 1947, within which to present herein their claims and answers;

Now, on motion of Graham & Morse, proctors for petitioner,

It Is Ordered that the defaults of any and all person or persons claiming damages of said petitioner or against said steamship "Frej" for any and all loss, destruction, damage or injury arising out of or occurring on the voyage of said S.S. "Frej" which is stated to have ended at the Port of San Francisco on the 8th day of May, 1947, or by reason of the matters set forth in said petition, other than said Rice Growers Association of California, a corporation, and Shipowners & Merchants Tugboat Company, a corporation, and Shipowners & Merchants Towboat Company, Limited, a corporation, who have either filed a claim an answer or obtained an extension of time within which to do so, all as hereinbefore set forth, be and the same are hereby entered; and

It Is Further Ordered that all issues raised by the petitioner herein and the answer thereto now on file, or any answer or [38] answers which may

hereafter be filed within the time granted by this Court, as hereinbefore set forth, or any additional time which may be granted by this Court, shall stand for trial before this Court according to the rules and practice thereof; and

It Is Further Ordered that all other proceedings on any and all proofs of claims now on file, or which may be hereafter filed within the time granted by this Court, as hereinbefore set forth, or within any additional time, which may be granted by this Court, be and they are hereby stayed until the trial and determination of this suit.

Dated San Francisco, California, October 8, 1947.

LOUIS E. GOODMAN,

United States District Judge.

[Endorsed]: Filed Oct. 8, 1947.

[39]

[Title of District Court and Cause.]

STIPULATION RE VALUE

It is hereby stipulated by and between petitioner and claimants, in lieu of submitting evidence to Commissioner Fox under and pursuant to the "Order of Reference" herein dated August 4, 1947, that the following constitute the facts based upon which this Honorable Court shall fix the amount of the limitation of liability fund under the provisions of R.S. 4281 et seq (46 U.S.C.A. paragraphs 181-195):

1. The Steamship "Frej", owned and operated by petitioner, loaded a cargo of about 5060 tons of rice shipped by the Rice Growers Association of California for carriage from San Francisco, California, to Havana, Cuba, pursuant to the terms, provisions and conditions of bills of lading, a true copy whereof is attached hereto as Exhibit "A" and hereby incorporated. The ship, with said rice cargo aboard, commenced her voyage and sailed from her dock in San Francisco at 8:00 p.m. on the evening of May 6, 1947. Within an hour thereafter and while still in San Francisco Bay, a fire broke out aboard the ship. The fire was extinguished during the early morning hours of May 7, 1947, and the ship returned to her dock at San Francisco, where all of the cargo was unloaded, the unloading having been undertaken without prejudice to, but for the best interests of all concerned and was completed on May 14, 1947, at 5:00 o'clock a.m.

2. After the fire, the ship required repairs to fit her for sea. Accordingly, specifications for repairs to correct damage to the ship resulting from the fire were prepared and bids were taken thereon. The following bids were received: [40]

(a) General Engineering and Dry Dock Company, Alameda, California—\$122,638.00—48 working days.

(b) Moore Drydock Company, Oakland, California—\$167,500.00—20 working days.

(c) Bethlehem Steel Company, San Francisco, California —\$154,780.00—40 working days.

(d) Todd Shipyard Corporation, Los Angeles, California—\$139,994.00—35 working days.

3. The bid of General Engineering and Dry Dock Company was accepted by petitioner and on or about May 23, 1947, the ship was taken to the repair yard of the General Engineering and Dry Dock Company at Alameda, California, for these repairs, and the repair work was begun on May 26, 1947.

4. In addition to work required in the specifications for which General Engineering and Dry Dock Company bid the sum of \$122,638.00, additional damage as the result of the fire was discovered as work progressed and was repaired at a cost of \$45,476.73. A minor item in the original specifications was deleted and the actual cost on the work covered by the original repair specifications totaled \$122,022.66. The aggregate cost of repairing damages to the ship resulting from the fire was \$167,498.99. During the time said repairs were being effected, betterments to the ship for the owner's account were effected in the amount of \$17,349.40. All repairs and betterments were completed on August 4, 1947.

5. Rice in Holds No. 2 and No. 3, amounting to about 1828 tons, having been affected and damaged by water, smoke and fire, was retained in the San Francisco Bay Region and disposed of there. About one hundred twenty-two tons of rice formerly loaded in Hold No. 2 and about 3110 tons of rice formerly loaded in Holds No. 1, 4 and 5, aggregating about 3232 tons of rice, were in condition to be carried and were carried to Havana on the basis hereinafter mentioned in Article 10 hereof.

6. On June 6, 1947, Rice Growers Association of California filed a libel in personam and in rem against the S.S. Frej, her engines, boilers, boats, machinery, tackle, apparel and furniture, etc., and against Rederiaktiebolaget Frode, a corporation, in the District Court of the United States, Northern District of California, Southern Division, under Proceeding No. 24958-G. Pursuant thereto, the vessel was seized and reduced to the possession of the United States Marshal of said Court and for *Said* ~~and~~ District and remained in his possession from June 6, 1947 to and including August 9, 1947.

7. On June 19, 1947, J. H. Winchester & Co., Inc., on behalf of the ship and her owners, cabled notice of abandonment of the voyage to Rice Growers Association of California and to the various consignees in Cuba. A copy of said cable is attached hereto marked Exhibit B and hereby incorporated.

8. On July 17, 1947, Rice Growers Association of California filed an amendment to its libel in said proceeding No. 24958-G and which said libel and amendment to libel is hereby incorporated.

9. On July 25, 1947, petitioner filed a petition for limitation of liability in the District Court of the United States for the Northern District of California, Southern Division, under proceeding No. 25003-G, and which petition is hereby incorporated.

10. Subsequent to June 19, 1947, a dispute having arisen between the parties resulting from the sending of notice of abandonment referred to above

in Article 7 and petitioner's ^{Re Fosa} ~~refused~~ to reload and carry the rice to Havana, negotiations were entered into between petitioner and cargo interests to have the said 3232 tons of rice carried by the ship to Havana, which negotiations resulted in a written agreement, a copy of which agreement is attached hereto, [42] marked Exhibit "C" and hereby incorporated.

11. The ship left General Engineering and Dry Dock Co. on August 2, 1947 at 8:50 a.m. and repairs were completed in San Francisco on August 4, 1947.

12. Pursuant to said agreement (Exhibit "C") and between August 4 and August 8, 1947, the said about 3232 tons of rice formerly loaded in Holds No. 1, 2, 4 and 5 were reloaded on the ship at San Francisco. On August 11, 1947, the ship sailed from San Francisco for Havana with only said 3232 tons of August 31, 1947, and completed discharge of the said 3232 tons of rice on September 18, 1947.

13. For limitation of liability values, the following values are stipulated at the times noted:

rice cargo aboard and she arrived in Havana on

			Freight		
			Aggregate bill of lading charges		
			total \$101,977.03, which in-		
			cluded the following items:		
May 6, 1947	Vessel \$255,000	Stores \$16,815	Ocean freight	\$93,104.00	
(Prior to fire)			Havana handling fee	5,060.03	
			Manifest fee	18.00	
			Handling chgs. at		
			San Francisco	2,024.01	
			Wharfage at San		
			Francisco	1,770.99	
May 8, 1947	106,000	8,329	"	"	"
June 19, 1947	117,000	3,000	"	"	"
Aug. 4, 1947	275,000	21,825	"	"	"
Sept. 18, 1947	275,000	16,005	"	"	"

The vessel was purchased in Seattle, Washington by petitioner, pursuant to contract dated March 4, 1947, from Griffiths Steamship Company for the price of \$277,500. In addition thereto, pursuant to said contract, petitioner paid for unbroached stores, supplies and fuel oil the sum of \$8,632.61.

Dated San Francisco, the 28th day of May, 1948.

GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,

Proctors for Rice Growers Association of Calif.
GRAHAM & MORSE,
CLARENCE G. MORSE,
Proctors for Petitioner.

WRIGHT & McKEON,
Proctors for The Shipowners & Merchants Tugboat
Company and Shipowners & Merchants Towboat
Co., Ltd.

(Here follows Exhibits B and C.)

EXHIBIT "B"

Cable sent June 19, 1947 by J. H. Winchester & Co., Inc. to receivers and shippers of the rice cargo in connection with the abandonment of the voyage.

"Frej on account various matters including but not being limited to extraordinary delays and expenses arising as a result of May 6, 1947 fire and acting under authority of applicable bills lading and otherwise owner and Master have elected to abandon voyage and you are hereby notified that voyage of the S.S. "Frej" from San Francisco to Havana, Cuba is hereby abandoned. You are further notified that the rice is at your expense and risk and delivery thereof may be obtained by you immediately in San Francisco upon your posting satisfactory general average security."

EXHIBIT "C"

Dated July 26, 1947.

Frej—May, 1947

Memorandum of agreement re forwarding sound cargo.

1. Sound rice discharged from Frej will be reloaded and carried by the Frej under the terms of the original bills of lading without additional freight, ship bearing all loading and discharging costs which would be paid by the ship under the original bills of lading if it were now for the first time receiving the sound rice for such carriage.

2. Owners of sound cargo will pay the ship Ten Thousand (\$10,000.00) Dollars, which sum is not to be included in determining limitation fund nor the contributory values in general average. Owners and underwriters of sound rice waive all claims they may have to recover any part of said \$10,000.

3. The second cause of action in the pending libel by cargo against ship (for recovery of freight in the amount of \$95,000.00) will be dismissed without prejudice.

4. Storage charges covering period sound rice has been on Pier 45-C will be paid in the first instance by the Frej, ultimately liability for such item to abide decision in pending or future litigation and/or determination of general average liability.

5. Cost of segregating and classifying sound rice on dock will be paid in the first instance by cargo, ultimate liability for such item to abide decision in pending or future litigation and/or determination of general average liability.

6. The carrying on of the cargo and/or this agreement shall in no way prejudice any right or rights which either party now has and shall not affect the present status quo of the purported abandonment of the voyage at San Francisco, California.

7. Cargo has now furnished full general average security and the Frej and her owners will not require further general average security.

Method of Carrying Out Agreement

The procedure to release the vessel and to carry out the terms of the above agreement shall be as follows:

1. An ad interim stipulation shall be executed by the parties in the limitation proceedings providing for a bond in the face value of \$290,250.00 without interest.

2. The parties in the limitation proceedings will stipulate for the issuance of a restraining order applying to all pending actions except the second cause of action in the cargo libel (freight in the amount of \$95,000.00) and the wage claims of Eriksson and Hamalainen.

3. The parties will stipulate that an order may issue allowing the vessel to move from her present position to Pier 45-C, San Francisco, remaining within the possession of the Marshal, but without a keeper on board.

4. The sound rice will be loaded aboard the vessel in accord with the terms of the foregoing agreement, with stowage approved by surveyors Genereaux & Hansen or other surveyors mutually satisfactory to all parties.

5. When the sound rice is fully loaded on the vessel, and the vessel owners have complied with all other provisions of the foregoing agreement, cargo owners will file a dismissal without prejudice of the second cause of action in the cargo libel.

6. When the vessel has cleared the port of San Francisco with said sound cargo on board, cargo will immediately pay to J. H. Winchester & Co.,

Inc., agents for the Frej, the sum of Ten Thousand (\$10,000.00) Dollars as provided in the foregoing agreement.

[Endorsed]: Filed May 26, 1948.

In the United States District Court for the Northern District of California, Southern Division.

No. 25,003-G

In the Matter of the Petition of REDERIAKTIE-BOLAGET FRODE, a corporation, for exoneration from or limitation of liability of the owner of the Steamship Frej:

ORDER FIXING AMOUNT OF
LIABILITY FUND

In this proceeding for the limitation of liability of the owners of the Steamship "Frej," the Court is called upon to fix the amount of liability fund under the provisions of 46 U.S.C. Sec. 181-195.

I am satisfied that June 19, 1947, is the date upon which values should be fixed. *Place v. Norwich and New York Transportation Co.*, 118 U. S. 468; *Great Western*, 118 U. S. 520; *Pacific Coast Co. v. Reynolds*, 114 Fed. 877, (9 Cir.); *Boston Marine Insurance Co. v. Metropolitan Redwood Lumber Co.* (9 Cir.) 197 Fed. 703.

Accordingly the Court fixes the value of the vessel for the purposes of this proceeding

at	\$117,000.00
the value of its stores at.....	3,000.00
	<hr/>
	\$120,000.00
the value of earned freight at.....	93,104.00
	<hr/>
Total	\$213,104.00

Dated August 5, 1948.

LOUIS E. GOODMAN,
United States District Judge.

[Endorsed]: Filed Aug. 5, 1948. [46]

[Title of District Court and Cause.]

PETITION FOR APPEAL OF DAMAGE
CLAIMANT RICE GROWERS ASSOCIA-
TION OF CALIFORNIA, A CORPORATION

Rice Growers Association of California, a corporation, damage claimant herein, being aggrieved by the Order Fixing Amount of Liability Fund made and entered herein on the 5th day of August, 1948, by the United States District Court, claims an appeal from said order and prays that said appeal may be allowed.

Dated this 20th day of August, 1948.

/s/ GEORGE H. HAUERKEN,
/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant Rice Growers Association of California, a corporation.

[Endorsed]: Filed Aug. 20, 1948. [67]

[Title of District Court and Cause.]

NOTICE OF GENERAL APPEAL

To: Rederiaktiebolaget Frode, a corporation, petitioner herein, and to Clarence G. Morse, Esq. and Messrs. Graham & Morse, its Proctors:

Please take notice that Rice Growers Association of California, a corporation, damage claimant herein, hereby appeals to the next United States Circuit Court of Appeals for the Ninth Circuit from the Order Fixing Amount of Liability Fund made and entered by the above entitled Court on the 5th day of August, 1948, and from each and every part of said order.

Dated this 19th day of August, 1948.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant and Appellant Rice Growers Association of California, a corporation. [68]

(Acknowledgment of Service.)

[Endorsed]: Filed Aug. 20, 1948.

[69]

[Title of District Court and Cause.]

ORDER ALLOWING APPEAL

Pursuant to the petition for appeal of Rice Growers Association of California, a corporation, damage claimant herein, dated August 20th, 1948, and presented this date to the Court:

It Is Hereby Ordered that the appeal of damage claimant, Rice Growers Association of California, a corporation, from the Order Fixing Amount of Liability Fund made and entered herein on August 5th, 1948, be allowed as prayed for and that said Rice Growers Association of California, a corporation, file an appeal bond of a corporate surety in the amount of Seventy-five Hundred (\$7500.00) Dollars, and that, upon the filing of said bond, all proceedings under said order be stayed.

Dated this 20th day of August, 1948.

/s/ LOUIS E. GOODMAN,
United States District Judge.

[Endorsed]: Filed Aug. 20, 1948. [70]

[Title of District Court and Cause.]

ASSIGNMENT OF ERRORS

Rice Growers Association of California, a corporation, damage claimant and appellant herein, hereby assigns error in the proceedings, orders and decisions of the District Court in the above entitled cause as follows:

1. The Court erred in holding that June 19th, 1947, is the date as of which the limitation of liability fund is to be fixed.
2. The Court erred in holding that for the purpose of said limitation of liability fund the value of the Steamship "Frej" was to be fixed at One Hundred Seventeen Thousand (\$117,000.00) Dollars.

3. The Court erred in holding that for the purpose of said limitation of liability fund the value of the pending freight of said Steamship "Frej" was to be fixed at Ninety-three Thousand One Hundred Four (\$93,104.00) Dollars. [71]

4. The Court erred in holding that for the purpose of said limitation of liability fund the value of the stores of the Steamship "Frej" was to be fixed at Three Thousand (\$3,000.00).

5. The Court erred in fixing the total amount of the limitation of liability fund at Two Hundred Thirteen Thousand One Hundred Four (\$213,104) Dollars.

6. The Court erred in holding that the voyage of the Steamship "Frej" terminated in San Francisco, California, on June 19th, 1947.

7. The Court erred in holding that Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, was justified, as owner of the Steamship "Frej" in terminating her voyage in San Francisco, California, on June 19th, 1947.

8. The Court erred in failing to hold that the voyage of the Steamship "Frej" ended in Havana, Cuba, on September 18th, 1947.

9. Assuming that the Court was justified in fixing the amount of the limitation of liability fund as of a date earlier than the date of the end of the voyage (September 18th, 1947), the Court erred in adopting June 19th, 1947, as such date, instead of August 4th, 1947, the date as of which said Rederiaktiebolaget Frode became entitled to claim the benefits of the limitation of liability statute (46

U.S.C., Sec. 181-195) by posting its ad interim stipulation for value.

Dated this 19th day of August, 1948.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant and Appellant—
Rice Growers Association of California, a corporation. [72]

(Acknowledgment of Service.)

[Endorsed]: Filed Aug. 20, 1948.

[73]

[Title of District Court and Cause.]

STIPULATION AS TO SERVICE OF PAPERS
ON APPEAL

It Is Hereby Stipulated By and Between the parties hereto, through their respective proctors, that there need be no service made upon The Shipowners and Merchants Tugboat Company, a corporation, and Shipowners and Merchants Towboat Co., Ltd., a corporation, salvage claimants herein, or upon Joseph B. McKeon, Esq., and Messrs. Wright & McKeon, their proctors, of any notices, pleadings, briefs and/or papers of whatsoever nature heretofore filed or hereafter to be filed herein by Rice Growers Association of California, a corporation, damage claimant and appellant herein, and by Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, in connection with the appeal taken by said Rice Growers

Association of California from the Order Fixing Amount of [77] Liability Fund made and entered by the above entitled Court on the 5th day of August, 1948.

Dated this 24th day of August, 1948.

/s/ JOSEPH B. McKEON,

/s/ WRIGHT & McKEON,

Proctors for Salvage Claimants The Shipowners and Merchants Tugboat Company and Ship-owners and Merchants Towboat Co., Ltd.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant and Appellant Rice Growers Association of California.

/s/ CLARENCE G. MORSE,

/s/ GRAHAM & MORSE,

Proctors for Petitioner and Appellee Rederiaktiebolaget Frode.

[Endorsed]: Filed Aug. 25, 1948.

[78]

[Title of District Court and Cause.]

STIPULATION AS TO APOSTLES ON APPEAL

It is hereby stipulated by and between Rice Growers Association of California, a corporation, damage claimant and appellant herein, and Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, through their respective proctors and pursuant to Rule 37(4) of the Rules of the

United States Circuit Court of Appeals for the Ninth Circuit, that the Apostles on Appeal in the above entitled cause shall include the following:

1. **Petition for Limitation of Liability.**
2. Answer of Rice Growers Association of California to Petition for Limitation of Liability.
3. Order of Reference for Appraisement.
4. Stipulation Re Amount of Ad Interim Stipulation of Value Pending Appraisement.
5. Order for Ad Interim Stipulation. [79]
6. Ad Interim Stipulation for Value Pending Appraisement.
7. Amended Order for Monition, Fixing Time and Place for Filing Claims and Restraining Actions.
8. Order Noting Defaults.
9. Stipulation Re Value, dated and filed May 28th, 1948, including Exhibits B and C attached thereto.
10. Order Fixing Amount of Liability Fund.
11. Findings of Fact and Conclusions of Law (proposed by Rice Growers Association of California).
12. Final Decree (proposed by Rice Growers Association of California).
13. Findings of Fact and Conclusions of Law and Final Decree as Proposed by Petitioner.
14. Findings of Fact and Conclusions of Law (proposed by Petitioner).
15. Final Decree (proposed by Petitioner).
16. Order Exonerating Ad Interim Stipulation for Value, Releasing Sureties and Principals

Thereon, and Approving Stipulation for Value.
(proposed by Petitioner.)

17. Reporter's Transcript of the proceedings at the hearing had before the Honorable Louis E. Goodman on the 16th day of August, 1948.

18. Petition for Appeal.

19. Order Allowing Appeal.

20. Bond on Appeal Staying Execution.

21. Notice of General Appeal.

22. Citation on Appeal.

23. Assignment of Errors.

24. Stipulation as to Service of Papers on Appeal.

25. Praeceptum for Apostles on Appeal.

26. Stipulation as to Apostles on Appeal.

27. Copy of the Docket of the Clerk of the District Court. [80]

It Is Hereby Further Stipulated that

(a) The Libel

(b) The Amendment to Libel

which are incorporated by reference in and are referred to in paragraph (6) and paragraph (8) of the above mentioned Stipulation Re Value, dated May 28th, 1948, may be omitted from the record.

It Is Hereby Further Stipulated that the copy of the Bill of Lading issued by Rederiaktiebolaget Frode to Rice Growers Association of California and attached as Exhibit A to both the above mentioned Petition for Limitation of Liability and the above mentioned Stipulation Re Value, dated May 28th, 1948, need not be copied into the Record on Appeal, but that the copy of said Bill of Lading

attached to the original of said Stipulation Re Value, dated May 28th, 1948, may be transmitted to the United States Circuit Court of Appeals for the Ninth Circuit and deemed a part of the Record on Appeal herein.

Dated August 30th, 1948.

/s/ CLARENCE G. MORSE,

/s/ GRAHAM & MORSE,

Proctors for Petitioner and Appellee, Rederiaktiebolaget Frode.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant and Appellant, Rice Growers Association of California.

[Endorsed]: Filed Aug. 31, 1948.

[81]

[Title of District Court and Cause.]

PRAECIPE FOR APOSTLES ON APPEAL
To the Clerk of the above entitled Court:

Rice Growers Association of California, a corporation, Damage Claimant and Appellant herein, having appealed to the United States Circuit Court of Appeals for the Ninth Circuit from the Order Fixing Amount of Liability Fund made and entered herein by the above entitled Court on the 5th day of August, 1948, you are hereby requested to prepare and certify Apostles on Appeal, in accordance with the Stipulation as to Apostles on Appeal entered into on the 30th day of August, 1948, by and between Rice Growers Association of California, a corporation, Damage Claimant and Appellant herein, and Rederiaktiebolaget Frode, a cor-

poration, Petitioner and Appellee herein, and filed herein on the 31st day of August, [82] 1948, and to file said Apostles on Appeal in said Appellate Court in due course.

Dated this 30th day of August, 1948.

/s/ GEORGE H. HAUERKEN,
/s/ HAUERKEN & ST. CLAIR,
Proctors for Damage Claimant and Appellant, Rice
Growers Association of California.

(Acknowledgment of Service.)

[Endorsed]: Filed Aug. 31, 1948. [83]

[Title of District Court and Cause.]

ORDER EXTENDING TIME TO DOCKET

Good cause appearing therefor, it is hereby Ordered that the Appellant herein may have to and including November 8, 1948, to file the Record on Appeal in the United States Circuit Court of Appeals in and for the Ninth Circuit.

Dated September 28, 1948.

LOUIS E. GOODMAN,
United States District Judge.

[Endorsed]: Filed Sept. 28, 1948. [84]

District Court of the United States
Northern District of California

CLERK'S CERTIFICATE

I, C. W. Calbreath, Clerk of the District Court of the United States, for the Northern District of California, do hereby certify that the foregoing 90 pages, numbered from 1 to 90, inclusive, contain a full true, and correct transcript of the records and proceedings in the case of In the Matter of Rederiaktiebolaget Frode, a corporation, for exoneration from or limitation of liability as owner of the steamship "Frej", No. 25003-G, as the same now remain on file and of record in my office.

I further certify that the cost of preparing and certifying the foregoing transcript of record on appeal is the sum of \$15.00 and that the said amount has been paid to me by the Attorney for the appellant herein. And I further Certify that annexed hereto is the original Citation on Appeal and Admission of Service.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court at San Francisco, California, this 29th day of October, A. D. 1948.

(Seal)

C. W. CALBREATH,
Clerk.

[Title of District Court and Cause.]

CITATION ON APPEAL

United States of America—ss.

The President of the United States of America to Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, Greeting:

You are hereby cited and admonished to be and appear at a United States Circuit Court of Appeal for the Ninth Circuit to be held at the City of San Francisco, in the State of California, within forty (40) days from the date hereof, pursuant to an order allowing an appeal, of record in the clerk's office of the United States District Court for the Northern District of California, wherein Rice Growers Association of California, a corporation, is damage claimant and appellant, and you are appellee, to show cause, if any there be, why the Order rendered against the said appellant, as in the said Order Allowing Appeal mentioned, should not be corrected, and why speedy justice should not be done to the parties in that behalf.

Witness, the Honorable Louis E. Goodman, United States District Judge for the Northern District of California, this 20th day of August, 1948.

/s/ LOUIS E. GOODMAN,
United States District Judge.

Attest:

(Seal) /s/ C. W. CALBREATH,
Clerk.

(Acknowledgment of Service.)

[Endorsed]: Filed Aug. 25, 1948.

In the Southern Division of the United States
District Court for the Northern District of
California

Before: Hon. Louis E. Goodman, Judge.

In Admiralty—25,003-G

In the Matter of the Petition of Rederiaktiebolaget
Frode, a corporation, for exoneration from or
limitation of liability as owner of the Steamship
Frej.

REPORTER'S TRANSCRIPT

Monday, August 16, 1948

2:45 o'clock p.m.

Appearances: For the Petitioner: Clarence G.
Morse, Esq. For the Respondent: George H. Hauer-
ken, Esq.

The Clerk: In re petition of Frode.

Mr. Hauerken: If it please the Court, this is a
limitation of liability proceeding.

Mr. Morse: If it please the Court, we are the
moving parties in this matter.

Mr. Hauerken: I don't know whether counsel
is the moving party, but let him start if he wishes
to.

Mr. Morse: This is in connection with the limi-
tation of liability bond, this matter.

On August 5th this Court made a ruling, a
decision, fixing the limitation fund at two hundred
thirteen thousand dollars. Because Mr. Hauerken
indicated he was planning to appeal from that
motion, we made a formal motion at this time

rather than bringing in a bond in the amount fixed in the order, a bond for the approval of the Court. Perhaps in view of the fact that Mr. Hauerken is now indicating that he is planning to appeal, it might be inappropriate at this time to reduce the bond; so that I am perfectly frank to say that I think that the motion we have here is meritorious, but if Mr. Hauerken is sincere in his statement that he is going to appeal, the probabilities are that if he makes a request for stay, the application would be granted pending his filing his appeal.

The Court: Well, what motion is it?

Mr. Morse: I have a motion for an order approving a new bond in the amount fixed, some two hundred thirteen odd thousand dollars, and an application for an order exonerating the bond.

The Court: Of course if Mr. Hauerken is going to appeal, I think he is entitled to have the status quo.

Mr. Morse: That is why I say we are sort of in betwixt and between on this motion.

The Court: Is that all that is before the Court?

Mr. Morse: That is all that is before the Court on a formal motion, yes sir.

Mr. Hauerken: As a matter of fact, it probably shouldn't be before the Court on a formal motion.

Mr. Morse: Ordinarily, I would have presented the matter to the Court in the chambers.

Mr. Hauerken: On August 5th your Honor ordered a judgment fixing the liability fund in this limitation proceeding, having also last August

made an order for an ad interim stipulation and referred the matter to a commissioner for the purpose of hearing. Subsequent thereto we entered into an agreed statement of fact which was submitted to your Honor in lieu of taking the matter up with Mr. Fox, and your Honor made this order fixing the amount of liability fund. That order is dated August 5th.

We intend to appeal. Now this order is either an interlocutory order which requires a notice of appeal within 15 days, or it is a final order which requires a notice of appeal within 3 months. I think that it is a final order, but I want to be certain and see to it that our notice of appeal is on file within the 15 days from August 5th.

Now your Honor did not indicate in this order whether or not the findings should be filed. We did some research work, and while we found some civil cases that stated that where a matter is heard on an agreed statement of fact that findings should not be had, yet we found no admiralty cases. We found an admiralty case which went up on appeal on contested issues, which was reversed on the sole ground that no findings of fact were entered in to. So, not wanting to find ourselves in the Appellate Court and having the Appellate Court say, "No judgment has been entered, therefore you are premature," we prepared and submitted to counsel a stipulation that the order that your Honor made might be deemed to be the findings of fact and conclusions of law and decree. Counsel refused to sign that stipulation; I have his letter here saying that he refused to do it.

We waited the five days prescribed by the rules, for counsel to submit proposed findings of fact, and he not having done so, we then, the day after, lodged with the Court our proposed findings of fact and conclusions of law and our proposed decree. There is no provision for the—shall we say—successful litigant thereafter to file a proposed findings of fact, but they were served on me this morning after Court had started.

So the matter before the Court, and as formally as we could present it, was that after this five day period had elapsed wherein the other side might propose to your Honor findings of fact and conclusions of law, we lodged them with the Clerk and they are now before your Honor. In that, we suggest that there should be a stay of execution until the appeal on this particular matter has been concluded.

On Thursday, and not five days before the date of this hearing, counsel presented a formal motion wherein they purport to exonerate the old bail, yet not within the five day time. We waived that; therefore there is the only pretence of formality in this matter being on the law and motion calendar.

As I say, we are going to file a notice of appeal, and I would like to be in a position to do that within 15 days. So your Honor can either reject everything and conclude that the order that you made is all that needs to be done, in which event we will appeal from that order—and the Appellate Court might say that that is not formal enough.

The Court: We can take care of that right now by making the proper record. However, in these limitation of liability proceedings, there is more to it than just the Court fixing the amount.

Mr. Hauerken: Oh yes.

The Court: In this very proceeding the matter of exoneration has to be determined, and that is the trial of the case, isn't it really?

Mr. Hauerken: Yes. All your Honor did, your Honor made something in the nature of a memorandum on the fixing of the value at so much. But you did not make any order reducing the bond; therefore there is really nothing for us to appeal. That is, it may be so argued.

The Court: Let's assume that we went on and determined the matter of exoneration of liability, and irrespective of which way it would go, either side would take an appeal. Suppose you were the appealing party, for argument's sake. You could still raise in that appeal the same question.

Mr. Hauerken: Here is the practical difficulty. Right now Sweden enjoys a certain amount of freedom, even with their exchange difficulties. And in spite of that exchange, we are going after this bond if we are successful in this litigation. Right now Sweden is not within the Iron Curtain; maybe a year or so from now she may be. We are not interested so much in a personal judgment against this Swedish Steamship Company as we are in securing a judgment against the Royal Indemnity Company, which is the guarantor on this bond. It is a very practical difficulty.

The Court: At least to the extent of the ad interim stipulation, the status quo could be maintained?

Mr. Hauerken: If the ad interim stipulation were maintained, that would suit me fine.

The Court: Well I would think Mr. Morse practically agreed, unless I misunderstood him, with that, that you were entitled, as I think any litigant would be under the circumstances to a stay of the actual execution so that eventually if it is determined that this order which I made is incorrect, to the extent of the ad interim stipulation you would be protected during the appeal.

Mr. Hauerken: The only further order that I want, your Honor, is this: In this proposed findings of fact, we have incorporated by reference the agreed statement of facts, and in the conclusions of law we have purported to say that which your Honor has done. I would prefer to appeal from a formal order predicated upon the findings of fact and conclusions of law, and then to appeal from this.

The Court: How can I make any findings of fact in a case in which the facts are stipulated to and where there was by agreement submitted to the Court merely a question of law as to the time at which the value should be affixed?

Mr. Hauerken: I think that you are entirely correct in that, your Honor, but the Appellate Courts sometimes say, "You should have done this." Now if your Honor will either do or not do, and whatever you do, we are satisfied with it. I

will put it that way, that is, so long as we get a stay.

The Court: Well I will say for the record now, for whatever protection it will afford to the aggrieved party, that I intend the order which I filed as being final, that I did not regard it as necessary to file any findings of fact in the matter because of the fact that the precise issue was submitted to me on a stipulation of facts, and by agreement the Court determined a matter of law, and for that reason, this Court states this is the order that the Court made, that it doesn't need any findings of fact and that in the event counsel wish to appeal, that they are entitled to, and the Court holds that they may, appeal from that same order of the Court. Now that is the intention of the Court, so that my colleagues in the Appellate Court, when they read this statement of what took place today, may find no confusion in their minds. That is what this Court intended.

Now that is the basis upon which the Appellate Court has ruled in several of these cases heretofore where there has been doubt.

* * * *

CERTIFICATE OF REPORTER

I, (Illegible), Official Reporter, pro tem certify that the foregoing 14 pages is a true and correct transcript of the matter therein contained as reported by me and thereafter reduced to type-writing, to the best of my ability.

[Endorsed]: Filed Sept. 15, 1948.

[Endorsed]: No. 12074. United States Court of Appeals for the Ninth Circuit. Rice Growers Association of California, a Corporation, Appellant, vs. Rederiaktiebolaget Frode, a Corporation, Owner of the Steamship "Frej", Appellee. Apostles on Appeal. Appeal from the District Court of the United States for the Northern District of California, Southern Division.

Filed October 29, 1948.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

[Title of District Court and Cause.]

STIPULATION SUPPLEMENTING STIPULATION AS TO APOSTLES ON APPEAL AND AMENDING PRAECIPE FOR APOSTLES ON APPEAL

It Is Hereby Stipulated by and between Rice Growers Association of California, a corporation, Damage Claimant and appellant herein, and Rederiaktiebolaget Frode, a corporation, Petitioner and appellee herein, through their respective proctors and pursuant to Rule 37(4) of the Rules of the United States Court of Appeals for the Ninth Circuit, that the claim filed herein on September 8th, 1947, by said Rice Growers Association of California shall be added to the Apostles on Appeal in the above-entitled cause.

It is hereby Further Stipulated that said Apostles on Appeal shall include this Stipulation.

And it is hereby Further Stipulated that the Praeceptum for Apostles on Appeal heretofore filed herein and directed to the Clerk of the above-entitled Court shall be deemed amended to the extent necessary to carry out the terms of this Stipulation.

Dated this 23rd day of December, 1948.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Rice Growers Association of California Damage Claimant and Appellant.

/s/ CLARENCE G. MORSE,

/s/ GRAHAM & MORSE,

Proctors for Rederiaktiebolaget Frode Petitioner and Appellee.

[Endorsed]: Filed December 23, 1948. Paul P. O'Brien, Clerk.

[Title of District Court and Cause.]

CLAIM

And now comes the Rice Growers Association of California in the above matter and makes claim against the above named Rederiaktiebolaget Frode, a corporation, and of said S.S. "Frej", as follows:

(a) At all times herein mentioned, claimant was and now is a corporation organized and existing under and by virtue of the laws of the State of California.

(b) At all times herein mentioned, petitioner was and now is the owner and operator of the Steamship "Frej" which was and now is a general ship engaged in the common carriage of merchandise for hire between, amongst others, the Port of San Francisco, California, and the Port of Havana, Cuba.

(c) On or about April 29, 1947, claimant delivered to the said Steamship "Frej" and to petitioner, at the Port of San Francisco, certain shipments of rice in good order and condition, to be carried from said Port of San Francisco to the Port of Havana, Cuba, there to be delivered in like good order and condition as when shipped, to the order of claimant, arrival notice to be addressed to various consignees as hereinafter set forth, and that said shipments were made in consideration of an agreed freight in the total sum of One Hundred One Thousand Nine Hundred Seventy-seven and 03/100 (\$101,977.03) Dollars, as hereinafter set forth, and in accordance with the terms of eighteen (18) bills of lading, as hereinafter set forth, then and there signed and delivered to claimant by the duly authorized agent and/or representative of petitioner and of said Steamship "Frej".

The bills of lading numbers, the notify addressees, the description of each shipment and the freight paid on each shipment, are as follows:

B/L No.	Notify Addressee	Shipment	Freight
1	Hijos De Pio Ferra. S.A.	6,000 cases) 7,000 sacks)	\$10,219.57
2	Hijos De Pio Ferra. S.A.	8,000 cases	4.151.90

B/L No.	Notify Addressee	Shipment	Freight
3	Hijos De Pio Ferra, S.A.	14,000 sacks	\$14,211.79
4	Messrs. Aguilera, Marganon y Cia	10,000 sacks	10,151.56
5	Messrs. Aguilera, Margannon y Cia	1,000 sacks	1,016.06
6	Messrs. Aguilera, Marganon y Cia	10,000 sacks	10,151.56
7	Messrs. Aguilera, Marganon y Cia	10,000 sacks	10,151.56
8	Pinan, Arxer y Cia, S.enC.	1,000 sacks	1,016.06
9	Pinan, Arxer y Cia, S.enC.	2,000 cases	1,038.73
10	J. Perez, S. A.	3,000 cases	1,557.59
11	J. Perez, S. A.	3,000 sacks	3,046.17
12	F. Bonet-y-Cia, S-enC	1,000 sacks	1,016.06
13	F. Bonet-y-Cia, S-enC	1,000 sacks	1,016.06
14	Carvajal-y-Cia, S-enC	8,000 cases	4,151.90
15	Carvajal-y-Cia, S-enC	7,000 cases) 5,500 sacks)	9,215.85
16	Carvajal-y-Cia, S-enC	13,500 sacks	13,704.26
17	Pelaez, Pirez, y Cia	6,000 cases	3,114.18
18	Pelaez, Pirez, y Cia	3,000 sacks	3,046.17

Thereafter, said Steamship "Frej" having on board said merchandise, sailed from the Port of San Francisco, en route to the Port of Havana, Cuba.

(d) While still in San Francisco Bay, and on May 6, 1947, a fire started in the boiler-room of said vessel thereafter spreading to the engine-room and the No. 3 compartment. That the rice loaded in the No. 2 and No. 3 compartments was badly damaged and/or destroyed by fire, smoke and water used to extinguish the fire. Thereafter, the entire cargo was discharged at San Francisco. Thereafter the cargo previously loaded in the Nos. 1, 4 and 5 compartments was reloaded in said vessel, having

suffered some handling damage, and said vessel and the rice loaded in Nos. 1, 4 and 5 compartments are now proceeding to Havana, Cuba, to complete the voyage contracted for in said bills of lading. Some of the damaged rice discharged from No. 2 and 3 compartments was reconditioned, as much as reconditioning could be effected, and then sold, and some of said rice was sold in its condition as discharged from said vessel. That reconditioning charges, surveyors' fees, transportation and other expenses were incurred by claimant to minimize and fix the loss and/or damage aforesaid.

(e) A salvage claim of Fifty Thousand (\$50,000) Dollars has been made by the Shipowners and Merchants Tugboat Company, a corporation, and Shipowners & Merchants Towboat Co., Ltd., a corporation, and a libel has been filed in this court pursuant thereto under Proceeding No. 25008-R, in Admiralty, seeking recovery of the sum of Fifty Thousand (\$50,000) Dollars from the Steamship "Frej" and the cargo of rice described in paragraph (c) of this claim.

(f) Said fire was proximately caused by the design or neglect of petitioner in that

(1) The said vessel being unseaworthy at the time of her purchase by petitioner in March-April, 1947, owing to the large amount of free oil on the tank tops immediately below the boilers and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the

ship, petitioner took no steps at any time to eliminate this fire hazard but petitioner sent said vessel on her said voyage in said condition, and

(2) Knowing the said vessel to be unseaworthy at the time of her purchase by petitioner in March-April, 1947, owing to a large amount of free oil on the tank tops immediately below the boilers, and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the ship, petitioner took no steps at any time to eliminate this fire hazard but petitioner sent said vessel on her said voyage in said condition, and

(3) Knowing the said vessel to be unseaworthy before and/or at the beginning of the voyage owing to a large amount of free oil on the tank tops immediately below the boilers, and a large amount of free oil in the engine-room bilges, and a large amount of oil immediately forward and to the side of the boilers on the forward boiler-room bulkhead and the skin of the ship, petitioner sent said vessel on her said voyage in said condition, and

(4) The said vessel being unseaworthy at the time of her said purchase due to insufficient fire-fighting equipment, petitioner took no steps at any time to remedy this lack, but petitioner sent said vessel on her said voyage in said condition, and

(5) Knowing the said vessel to be unseaworthy at the time of her said purchase due to insufficient fire-fighting equipment, petitioner took no steps

at any time to remedy this lack but petitioner sent said vessel on her said voyage in said condition, and

(6) Knowing the said vessel to be unseaworthy before and at the beginning of the voyage in that said vessel did not have on board and on duty competent engine-room officers and crew, petitioner sent said vessel on her said voyage in said condition.

By reason of the premises, the fire from the starboard boiler was communicated to the oily fire-room bulkhead and/or the oily skin of the ship and/or to the free oil on the tank tops immediately below the starboard boiler and then to the free oil in the engine-room bilges, or having started, was not promptly extinguished.

(g) Many sacks and cases of rice originally loaded in No. 2 and 3 compartments were damaged and/or destroyed and the damaged rice retained and disposed of in San Francisco and Sacramento, California. The balance of the rice suffered some handling damage, the exact nature and extent of which is unknown to claimant at this time. To the best information and belief of claimant, the loss and/or damage and/or expense as a result of said fire was and is:

Rice damaged and/or destroyed by fire and/or smoke and/or water
and sold at San Francisco and Sacramento:

B/L No.	Notify Addressee	C.I.F. Value
1, 2, 3	Hijos De Pio Ferra. S. A.....	\$ 81,760.31
4, 5, 6, 7	Aguilera. Marganon y Cia	154,249.59
8, 9	Pinan. Arxer & Cia. S. en C.....	438.22
10, 11	J. Perez, S. A.	19,333.11
12, 13	F. Bonet y Cia	158.34

B/L No.	Notify Addressee	C.I.F. Value
14, 15, 16	Carvajal y Cia, S. en C.....	\$114,429.10
17, 18	Pelaez, Pirez y Cia	42.47
		<hr/>
		\$370,411.14
Less salvage proceeds on the sale of said rice.....		129,191.26
		<hr/>
		\$241,219.88

The following expenses were incurred in reconditioning, sale, survey, etc.:

California Dehydrating Co.—reconditioning	\$ 19,273.06
River Lines—Transportation to dehydrating plant.....	7,780.12
P. J. Seale & Associates—Commission on sale of damaged rice	8,608.73
Genereaux & Hansen—Survey fee	100.00
Cost of cartons to repack	28.46
Department of Agriculture	318.70
Estimated Surveyors' fees	25,000.00
	<hr/>
	\$302,328.95
Estimated handling damages which cannot be ascer- tained until the S.S. "Frej" arrives at Havana, Cuba, and the cargo in Nos. 1, 4 and 5 compartments is dis- charged and surveyed	50,000.00
	<hr/>
Total.....	\$352,328.95

Claimant reserves the right to amend the claim herein advanced at such time as the actual loss and/or expense and/or damage is ascertained, this not being possible at this time owing to the fact that the S.S. "Frej" and her cargo have not yet arrived at destination.

(h) Prior to the date hereof, and by written assignment, claimant became the owner of the damaged and destroyed cases and sacks of rice hereinabove mentioned with respect to all of the named addressees, except Pinan, Arxer y Cia, S.

en C., and is entitled to maintain the claim herein set forth.

On all shipments mentioned herein and including those in which Pinan Arxer y Cia, S. en C., are the notifying addressees, claimant has been authorized in writing to prosecute these claims.

(i) Claimant and/or the various notify addressees have performed all of the conditions precedent contained in the contract of carriage on their part to be performed.

(j) By reason of the premises, claimant has sustained damage in the sum of Three Hundred Fifty-two Thousand Three Hundred Twenty-eight and 95/100 (\$352,328.95) Dollars, together with interest thereon at the rate of Seven (7%) Percent per annum from May 6, 1947, until paid.

(k) Said S.S. "Frej" and petitioner, and each of them, carelessly and negligently mixed said shipments of rice on loading in San Francisco, California. That said shipments were separately marked and are of different grades and values. That the reasonable cost of re-piling and segregating said shipments according to mark and grade and value as when delivered to said S.S. "Frej" and petitioner, and each of them, would be and is Three Thousand Nine Hundred Thirty-five and 08/100 (\$3,935.08) Dollars. By reason of the premises, claimant has sustained damage in the sum of Three Thousand Nine Hundred Thirty-five and 08/100 (\$3,935.08) Dollars, together with interest thereon at the rate of Seven (7%) Percent per annum from May 6, 1947, until paid.

It is not now possible, and will not be possible

before the legal adjudication thereof to state the amount of salvage and other claims allowed or proved against said cargo; but claimant makes further claim in addition to its damages for the loss of and/or damage to said cargo and makes such claim against Rederiaktiebolaget Frode and said S.S. "Frej" for all such sums as may be allowed or adjudged against said cargo, and hereby give notice of its intention to hold Rederiaktiebolaget Frode and S.S. "Frej" responsible for all salvage and other expenses which said cargo and its owners and claimant may sustain by reason of the said fire or otherwise, and for all moneys which said cargo and its owners and claimant may be called upon to pay other persons, firms and corporations by reason thereof.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN, AMES &

ST. CLAIR,

Proctors for Rice Growers Association of California, a corporation, Claimant.

State of California,

City and County of San Francisco—ss.

George H. Hauerken, being first duly sworn, deposes and says:

That he is one of the proctors for the Rice Growers Association of California, claimant herein: that he had read the foregoing **claim and knows** the contents thereof. That the same is true of his own knowledge, except as to the matters therein

stated to be alleged upon information and belief and as to those matters he believes it to be true.

The sources of his information and the grounds for his belief as to the matters therein stated to be alleged upon information and belief are statements and records contained in your affiant's office.

The reason this verification is not made by an officer of the claimant corporation is that none of the officers of said corporation are now within the County in which your affiant has his offices.

/s/ GEORGE H. HAUERKEN.

Subscribed and sworn to before me this 8th day of September, 1947.

(Seal)

ALFRED D. MARTIN,

Notary Public in and for the City and County of San Francisco, State of California.

(Affidavit of Service by Mail.)

[Endorsed]: Filed Sept. 8, 1947.

United States of America,
Northern District of California—ss.

I, C. W. Calbreath, Clerk of the United States District Court for the Northern District of California, do hereby certify the foregoing to be full, true and correct copies of the Stipulation Supplementing Stipulation as to Apostles on Appeal and Amending Praecipe for Apostles on Appeal, and Claim of Rice Growers Association of California, filed September 8, 1947, in the Matter of the Peti-

tion of Rederiaktiebolaget Frode, a corporation for Exoneration from or Limitation of Liability of the Ownership of the Steamship "Frej", Case No. 25003-G in Admiralty as the same now remains on file and of record in this office.

Attest my hand and the seal of the said United States District Court, Northern District of California, at San Francisco, California, this 23rd day of December, A. D. 1948.

(Seal) C. W. CALBREATH,
Clerk.

[Endorsed]: Filed December 23, 1948. Paul P. O'Brien, Clerk.

United States Court of Appeals
For the Ninth Circuit

No. 12074

RICE GROWERS ASSOCIATION OF CALI-
FORNIA, a corporation,

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE,
a corporation,

Appellee.

APPELLANT'S STATEMENT OF POINTS
RELIED UPON ON APPEAL

Appellant, Rice Growers Association of California, a corporation, hereby refers to points (1) to (9), inclusive, of its Assignment of Errors heretofore filed with the Clerk of the United States District Court, in and for the Southern Division

of the Northern District of California, and certified to the above entitled Court by said Clerk as part of the record on appeal, and adopts the same as its statement of points relied upon on appeal in accordance with the provisions of Rule 19, subd. 6 of the Rules of the above entitled Court.

/s/ GEORGE H. HAUERKEN,
/s/ HAUERKEN & ST. CLAIR,
Proctors for Appellant.

(Acknowledgment of Service.)

[Endorsed]: Filed October 29, 1948. Paul P. O'Brien, Clerk.

[Title of U. S. Court of Appeals and Cause.]

STIPULATION AS TO PARTS OF RECORD
NECESSARY FOR CONSIDERATION AND
TO BE PRINTED

It Is Hereby Stipulated by and between Rice Growers Association of California, a corporation, Damage Claimant, and appellant herein, and Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, through their respective proctors and pursuant to Rule 19(6) and Rule 37(4) of the Rules of the above entitled Court, that the following parts of the record certified to the above-entitled Court by the clerk of the United States District Court for the Northern District of California, Southern Division, are necessary for the consideration of the appeal in the above-entitled Court and are to be printed:

1. Petition for Limitation of Liability. (Record, Vol. 1, pp. 1-10 incl.)
2. Stipulation re Amount of Ad Interim Stipulation of Value Pending Appraisement. (Record, Vol. 1, pp. 11-12 incl.)
3. Ad Interim Stipulation for Value Pending Appraisement. (Record, Vol. 1, pp. 13-15 incl.)
4. Order for Ad Interim Stipulation. (Record, Vol. 1, pp. 16-17 incl.)
5. Order of Reference for Appraisement. (Record, Vol. 1, pp. 18-19 incl.)
6. Amended Order for Monition, Fixing Time and Place for Filing Claims and Restraining Actions. (Record, Vol. 1, pp. 20-23 incl.)
7. Answer of Rice Growers Association of California to Petition for Limitation of Liability. (Record, Vol. 1, pp. 24-35 incl.)
8. Order Noting Defaults. (Record, Vol. 1, pp. 36-39 incl.)
9. Stipulation re Value, including Exhibits "B" and "C" thereto. (Record, Vol. 1, pp. 40-44 incl.)
10. Order Fixing Amount of Liability Fund. (Record, Vol. 1, pp. 45-46 incl.)
11. Petition for Appeal. (Record, Vol. 1, p. 67.)
12. Notice of General Appeal. (Record, Vol. 1, pp. 68-69 incl.)
13. Order Allowing Appeal. (Record, Vol. 1, p. 70.)
14. Assignment of Errors. (Record, Vol. 1, pp. 71-73 incl.)
15. Stipulation as to Service of Papers on Appeal. (Record, Vol. 1, pp. 77-78 incl.)

16. Stipulation as to Apostles on Appeal. (Record, Vol. 1, pp. 79-81 incl.)

17. Praeceptum for Apostles on Appeal. (Record, Vol. 1, pp. 82-83 incl.)

18. Order Extending Time to Docket. (Record, Vol. 1, p. 84.)

19. Certificate of Clerk of District Court of the United States, Northern Division of California, to Transcript of Record on Appeal. (Record, Vol. 1, p. 91.)

20. Citation on Appeal. (Record, Vol. pp. 92-93 incl.)

21. The following part of the Reporter's Transcript of the proceedings at the hearing had before the Honorable Louis E. Goodman on the 16th day of August, 1948:

Beginning at page 2, line three thereof to and including page 8, line 20 thereof. (Record, Vol. 2.)

22. Certificate of Reporter to Reporter's Transcript. (Record, Vol. 2.)

23. Claim of Rice Growers Association of California. (Supplement to Record on Appeal.)

24. Stipulation Supplementing Stipulation as to Apostles on Appeal and Amending Praeceptum for Apostles on Appeal. (Supplement to Record on Appeal.)

25. Appellant's Statement of Points Relied
Upon on Appeal filed in the above-entitled Court.
26. This Stipulation.

Dated this 23rd day of December, 1948.

/s/ GEORGE H. HAUERKEN,

/s/ HAUERKEN & ST. CLAIR,

Proctors for Damage Claimant and Appellant, Rice
Growers Association of California.

/s/ CLARENCE G. MORSE,

/s/ GRAHAM & MORSE,

Proctors for Petitioner and Appellee, Rederiaktie-
bolaget Frode.

[Endorsed]: Filed December 23, 1948. Paul P.
O'Brien, Clerk.



No. 12,074

IN THE

United States Court of Appeals
For the Ninth Circuit

RICE GROWERS ASSOCIATION OF CALI-
FORNIA (a corporation),

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
"Frej",

Appellee.

APPELLANT'S OPENING BRIEF.

FILED

MAR - 2 1949

PAUL P. O'BRIEN,
CLERK

GEORGE H. HAUERKEN,
HAUERKEN & ST. CLAIR,

535 Russ Building, San Francisco 4, California,

Proctors for Appellants.

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No. 12,074

IN THE

**United States Court of Appeals
For the Ninth Circuit**

RICE GROWERS ASSOCIATION OF CALI-
FORNIA (a corporation),

Appellant,

VS.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
“Frej”,

Appellee.

APPELLANT'S OPENING BRIEF.

This is an appeal to the United States Court of Appeals for the Ninth Circuit from an order of the District Court of the United States for the Northern District of California, Southern Division, in admiralty, fixing the amount of the limitation of liability fund in a limitation of liability proceeding.

**JURISDICTION OF THE DISTRICT COURT AND OF
THIS HONORABLE COURT.**

This proceeding for exoneration from ~~one~~^{or} limitation of liability was brought by the owner of the SS "Frej", Rederiaktiebolaget Frode (hereinafter referred to as Frode), under the provisions of 46 U.S.C. sections 181-189 inclusive.

The petition of Frode (Apostles on Appeal, page 2) alleges that a fire broke out aboard the SS "Frej" as she was leaving San Francisco, California, on a voyage to Havana, Cuba and that the total claims against her were or might be in excess of her value and the value of her pending freight, at the end of her voyage. The petition prays for exoneration from liability for the consequences of that fire or, in the alternative, for limitation of liability therefor.

Two claims were filed in the Court below, one by appellant Rice Growers Association of California, (hereinafter referred to as Rice Growers), for damage to the cargo aboard the SS "Frej" and the other by salvage claimants who are not parties to this appeal. (See Apostles on Appeal, page 59.) The two claims were in excess of the value of the SS "Frej" and her pending freight.

Pursuant to a stipulation entered into by all the interested parties, the District Court ordered Frode to file an ad interim stipulation in the sum of \$290,250.00 (Apostles on Appeal, page 19), which Frode did. (Apostles on Appeal, page 15.)

Instead of having the amount of the limitation fund determined by a Commissioner, the parties sub-

mitted the question to the District Court on an agreed statement of facts, entitled "Stipulation Re Value" (Apostles on Appeal, page 45) on the basis of which the District Court made the order from which this appeal is taken.

The appellate jurisdiction of this Honorable Court rests upon 28 U. S. C., sections 225(a) and 227 (now 28 U. S. C., sections 1291 and 1292).

The order appealed from was held by this Honorable Court to be an appealable interlocutory order "determining the rights and liabilities of the parties" (28 U. S. C., section 227), in *Rice Growers Association of California v. Rederiaktiebolaget Frode* (December 13, 1948), 171 Fed. (2d) 662.

The petition for appeal of Rice Growers and the order allowing the appeal were both filed on August 20, 1948, within 15 days of the entry of the order appealed from in the District Court. (Apostles on Appeal, pages 55 and 56.) On the same date Rice Growers filed its notice of general appeal, which notice had theretofore been served on Frode. (Apostles on Appeal, page 56.)

STATEMENT OF THE CASE.

Rice Growers shipped approximately 5060 tons of rice (a non perishable cargo) aboard the SS "Frej" from San Francisco to Havana. The SS "Frej," owned and operated by Frode, left her San Francisco dock in the evening of May 6, 1947. Within an hour, and while she was still in San Francisco Bay, a fire

broke out in her fire room, which fire was not extinguished until the early morning hours of the next day. The SS "Frej" then returned to her dock at San Francisco where all of the cargo was unloaded. The rice affected and damaged by water, smoke and fire was retained and disposed of in the San Francisco Bay region. The balance (over 3200 tons) was carried to Havana by the SS "Frej."

Frode is a foreign corporation with no offices in the United States of America. It owns only one or two small ships which it operates in Scandinavian waters. Its purchase of the SS "Frej," which was acquired from American owners in Seattle, Washington, in the early part of 1947, was an isolated transaction. When the SS "Frej" left San Francisco for Havana, with the cargo of rice aboard, she was on her way to Sweden with no plans to ever return to this country.

On June 6, 1947, Rice Growers filed a libel in the District Court of the United States for the Northern District of California, Southern Division, for the recovery of damages in the amount of \$365,990.00. The SS "Frej" was seized and reduced to the possession of the United States Marshal. She remained in his possession until August 9, 1947, when she was released following the filing by Frode of its petition for limitation of liability and of the ad interim stipulation. The further prosecution of the libel theretofore filed by Rice Growers was enjoined and all proceedings between the parties were thereafter had in the limitation of liability proceeding.

The SS "Frej" was repaired in San Francisco between May 26, 1947 and August 4, 1947. On June 19, 1947, while the work was in progress, Frode gave a notice purporting to abandon the voyage. (Exhibit "B," Apostles on Appeal, page 51.) After completion of the repairs, however, the SS "Frej" carried the sound rice to Havana with no other cargo aboard and with ballast replacing the damaged rice. Discharge at Havana was completed on September 18, 1947. That carriage was made pursuant to an agreement of the parties (Exhibit "C," Apostles on Appeal, page 51) which provided:

"6. The carrying on of the cargo and/or this agreement shall in no way prejudice any right or rights which either party now has and shall not affect the present status quo of the purported abandonment of the voyage at San Francisco, California."

After Frode had given its notice of purported abandonment of the voyage, the libel theretofore filed by Rice Growers was amended to include a second cause of action in which Rice Growers demanded damages in the amount of \$95,000.00 to cover the cost of forwarding the sound rice to Cuba. The cost of such forwarding would have approximated that amount, since the SS "Frej," which was a tramp ship with rates cheaper than those of the regular lines, had charged and collected over \$100,000.00 as the cost of carrying the entire cargo. That second cause of action was dismissed by Rice Growers without prejudice as part of the agreement heretofore referred to for the carriage of the sound rice to Cuba. It was, of course,

cheaper for Rice Growers to dismiss that second cause of action without prejudice and to pay an additional \$10,000.00 for the carriage of the sound rice to Cuba (Apostles on Appeal, page 52), than to pay about \$95,000.00 to another ship and then try to collect that amount back from Frode.

For the purpose of the limitation fund the parties have stipulated to the following values for the SS "Frej" and her stores:

<u>Date</u>	<u>Vessel</u>	<u>Stores</u>	<u>Total</u>
(1) Immediately before the fire— (May 6th, 1947).....	\$255,000	\$16,845	\$271,845
(2) Immediately following the fire —(May 8th, 1947).....	106,000	8,329	114,329
(3) On the day on which Frode gave the notice of abandon- ment—(June 19th, 1947).....	117,000	3,000	120,000
(4) On the day on which the Dis- trict Court made its order as to the filing by Frode of an ad interim stipulation — (August 4th, 1947)	275,000	21,825	296,825
(5) On the day of the completion of the unloading operations in Cuba—(September 18th, 1947)	275,000	16,005	291,005

The parties have also stipulated as follows to the amount of the aggregate bill of lading charges:

Ocean freight	\$ 93,104.00
Havana handling fee	5,060.03
Manifest fee	18.00
Handling chgs. at San Francisco..	2,024.01
Wharfage at San Francisco.....	1,770.99
Total.....	\$101,977.03

Frode contended in the Court below that the limitation fund was to be determined as of May 8th or

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Wharfage at San Francisco.....	1,770.99
Total.....	\$101,977.03

Frode contended in the Court below that the limitation fund was to be determined as of May 8th or

June 19th. Rice Growers contended that the fund was to be determined as of September 18th.

The District Court held that the value of the SS "Frej" and her stores was to be determined as of June 19th, the day on which Frode gave the notice of purported abandonment of the voyage. The District Court also upheld the contention of Frode that the ocean freight alone (\$93,104.00) was to be included in the fund and rejected the contention of Rice Growers that the fund should also include, as part of the freight pending, the various handling, manifest and wharfage charges.

SPECIFICATIONS OF ERROR.

Assignments of error 1, 2, 3, 4, 5, 6, 7, 8 and 9 (Apostles on Appeal, pages 57-59) are relied upon by Rice Growers.

ARGUMENT.

(1) SPECIFICATIONS OF ERROR 1, 2, 4, 5, 6, 7 AND 8.

Specifications 1, 2, 4, 5, 6, 7 and 8 will be discussed together because they all relate to the question of whether or not the voyage ended on June 19th.

"1. The Court erred in holding that June 19th, 1947, is the date as of which the limitation of liability fund is to be fixed.

2. The Court erred in holding that for the purpose of said limitation of liability fund the value of the Steamship "Frej" was to be fixed at

One Hundred Seventeen Thousand (\$117,000.00) Dollars.

4. The Court erred in holding that for the purpose of said limitation of liability fund the value of the stores of the Steamship "Frej" was to be fixed at Three Thousand (\$3,000.00.)

5. The Court erred in fixing the total amount of the limitation of liability fund at Two Hundred Thirteen Thousand One Hundred Four (\$213,104) Dollars.

6. The Court erred in holding that the voyage of the Steamship "Frej" terminated in San Francisco, California, on June 19th, 1947.

7. The Court erred in holding that Rederiaktiebolaget Frode, a corporation, petitioner and appellee herein, was justified, as owner of the Steamship "Frej" in terminating her voyage in San Francisco, California, on June 19th, 1947.

8. The Court erred in failing to hold that the voyage of the Steamship "Frej" ended in Havana, Cuba, on September 18th, 1947.

(a) **The limitation fund is to be determined as of the end of the voyage.**

The right of Frode to limit its liability for the damage resulting from the fire is yet to be determined. That right is entirely statutory, and, before the question of whether or not it is entitled to limit its liability can be litigated, Frode must comply with the statutory requirements as to the giving of adequate security to the damage claimants. The pertinent part of the statute (46 U. S. C., section 185) is as follows:

“The vessel owner, * * * may petition a district court of the United States * * * for limitation of liability * * * and the owner (a) shall deposit with the court, for the benefit of claimants, a sum equal to the amount of the interest of such owner in the vessel and freight, or approved security therefor, and in addition such sums, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title, or (b) at his option shall transfer, for the benefit of claimants, to a trustee to be appointed by the court his interest in the vessel and freight, together with such sums, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title. Upon compliance with the requirements of this section all claims and proceedings against the owner with respect to the matter in question shall cease.”

Section 185 does not specify *the time* as of which the limitation of liability fund is to be determined. Numerous cases have passed upon that question, however, and it is now settled that the limitation of liability fund is to be determined as of the *end of the voyage*. Since Frode and Rice Growers disagree as to when and where the voyage ended, it will now be necessary to review those cases.

In *Place v. Norwich and New York Transportation Co.*, 118 U. S. 468, 6 S. Ct. 1150, 30 L. ed. 134, the owner of the “City Norwich” sought to limit its liability following a collision in which she sank. The Court held that the *sinking terminated her voyage*,

and that, for limitation of liability purposes, her value was to be taken as she was lying at the bottom of the ocean.

In *Thommessen v. Whitwell*, 118 U. S. 520, 6 S. Ct. 1174, 30 L. ed., 156, the owner of the "Great Western" sought to limit his liability following a collision between the "Great Western" and the "Daphne." The "Great Western" suffered no damage therefrom, but she was later stranded and wrecked, shortly before reaching her destination, from causes unrelated to the collision. The owner of the "Daphne" contended that the value of the "Great Western" immediately after the collision (\$150,000.00) should be used for limitation purposes. The Court held, however, that her value should be taken as of the end of her voyage, *that her voyage ended with her sinking*, and that her value as a sunken wreck (\$1,800.00) should accordingly be used for limitation purposes.

In *The Lara*, (1946, U. S. District Court for the Southern District of New York) 1947 A. M. C. 27, the facts were such that the rule of the "Great Western" worked for the benefit of the damage claimant instead of the shipowner. The "Lara," while on a voyage from New York to Barranquilla, Colombia was involved in a collision off the coast of North Carolina, and thereafter repaired in Florida. After the completion of the repairs she proceeded on her voyage, and instead of meeting with a further casualty, as the "Great Western" did, she arrived at Barranquilla and completed her voyage. The contention of the damage claimant, which was upheld, was precisely

the contention made by Rice Growers in this case, namely, that the value of the vessel at the end of her voyage should be used, *including the value of her repairs*.

It is thus clear that, in and of itself, the time of the collision, fire or other sea casualty, for which a vessel may incur liability and in which she may herself be damaged, has no bearing upon the time as of which her value is to be taken for limitation of liability purposes. Both the owner of the vessel involved in an accident and the persons to whom he may be liable as a result of that accident *must await the end of her voyage*. The shipowner is required to put up no more than her value at that time, irrespective of her value at the time of her accident, while the damage claimant must run the risk of her burning and sinking (as the "Great Western" sank) during the latter part of her voyage. On the other hand, a vessel may appreciate in value during her voyage, and irrespective of the cause of that appreciation, her owner must take the risk of her being worth more at the end of that voyage (the "Lara") just as the damage claimant takes the risk of her being worth less. The rule works both ways and not just one way as contended by Frode. *As long as the voyage continues*, the shipowner is not entitled to limit his liability to the value of his vessel immediately after the accident *or* to her value at the end of her voyage, whichever is less. He is only entitled to limit his liability to her value at the end of her voyage, irrespective of what her value may have been at any time during that voyage.

The question then reduces itself to whether or not the notice of abandonment given by Frode had the effect of legally terminating the voyage of the SS "Frej."

We do not know whether Frode will renew, before this Court, the contention made below that the voyage of the SS "Frej" terminated on May 8th. We must assume that it will rather seek to uphold the decision of the trial judge in view of the fact that, by giving notice of abandonment on June 19th, Frode indicated that it itself did not consider the voyage to have ended before that date. In any event it is clear that, if her voyage was not effectively terminated on June 19th, as we shall now proceed to establish, it was not terminated on May 8th or on any other date prior to the completion of the unloading operations in Cuba.

(b) Under the maritime law, Frode had no right to abandon the voyage.

The applicable law was settled long ago by the United States Supreme Court in the case of *The Maggie Hammond v. Morland*, 9 Wall. 435, 19 L. ed. 772. The "Maggie Hammond" had completed about half of her voyage from Scotland to Montreal, when she was damaged by heavy gales and forced to seek refuge in a Welsh port. She arrived there on September 17th, and, on November 3rd, after repairs had been made, she was certified to be in a "seaworthy state to proceed on her intended voyage." Her master, however, refused to reload the cargo and proceed

to fulfill the contract, alleging that the season was too far advanced. Instead she took on another cargo and sailed for Baltimore. The shipowner forwarded the cargo in another vessel at the end of the following May. Meanwhile a libel had been filed by the cargo owner and the "Maggie Hammond" was seized in Baltimore. In affirming the decree awarding damages to the cargo owner the Supreme Court stated:

"Grant that the conduct of the master in putting back is without objection, * * * the question then is: whether his subsequent conduct in refusing, after the repairs were finished, to complete the voyage or to procure another vessel, tranship the goods, and send them forward, and in sailing for another and a distant port under a new contract of affreightment, leaving the goods of the libelants in store, without making any provision for their transportation and delivery, constitutes a breach of the contract of affreightment. * * *

As agent of the owners the master is bound to carry the goods to their place of destination in his own ship, unless he is prevented from so doing by the act of God, the public enemy, or by the act of the shipper, or from some one of the perils expressly excepted in the contract of shipment. When the vessel is wrecked, or otherwise disabled in the course of the voyage, and cannot be seasonably repaired to perform the voyage, or cannot be repaired without too great delay and expense, the master is at liberty to tranship the goods and send them forward in another vessel, so as to earn the whole freight, but he is not entitled to recover for freight if he refuses to tranship the goods, unless he repairs his own vessel within a

reasonable time and carries them on to the place of delivery. * * * (19 L. ed. at p. 780.)

Duties remain to be performed by the master or the owner, after the vessel is disabled. His obligation of safe custody, due transport, and right delivery still continues and is by no means discharged or lessened while it appears that the goods have not perished in the disaster. * * *

Nothing will excuse the carrier under such circumstances but the causes stipulated in the bill of lading, and he is still bound, by virtue of his original contract, to use his utmost exertions to transport or send forward the goods to the port of delivery." (19 L. ed. at p. 781.)

The rule announced in *The Maggie Hammond v. Morland*, supra, is recognized throughout the maritime world. In *Carver on Carriage of Goods By Sea* (8th Ed. 1938) the shipowner is said at page 460 to be "bound to repair and complete the voyage, unless the damage by excepted perils is such that it would be unreasonable to require him to repair her * * * where the ship owner has in fact repaired the ship at the port of refuge, and might have carried on the cargo in her, his failure to do so is a breach of the contract, whether the repairing could reasonably have been required or not."

The leading British case is that of *Assicurazioni Generali v. SS. Bessie Morris Co.* (1892) 1 Q. B. 571, in which the Court said at pages 576 and 577:

"The duty of the shipowner is to complete the voyage if he can. If, owing to the perils of the

seas, he is compelled to put into an intermediate port for repair his duty is to refit and carry on such part of the original cargo as is fit to be carried on. * * * In a case of this description the original voyage is not regarded as broken up into two, viz., first, into one voyage from the port of sailing to the port of refuge, and secondly, into another voyage from such port to the port of destination.

* * * the voyage was not properly determined at Gibraltar (the port of refuge) unless its completion on the original terms was either physically impossible or so clearly unreasonable as to be impossible in a business point of view. * * * *I am not aware of any case which has decided that any expense short of * * * an expense greater than the value of the ship and freight when repaired sufficiently to complete the voyage, would be so clearly unreasonable as to be impossible in a business point of view.*" (italics added.)

The rule that a contract for carriage of goods by sea is not dissolved unless the ship is so injured that the cost of her repairs would exceed her value when repaired also prevails in the United States. See *Ellis v. Atlantic Mut. Ins. Co.*, 108 U.S. 342, 2 S. Ct. 746, 27 L. ed. 747.

In our case, however, none of the grounds upon which a ship owner is justified in abandoning a voyage were present. The "Frej" was not sunk; she was neither a total loss nor a constructive total loss. It was known in advance that the cost of her repairs would not exceed her value when repaired. It was

known in advance that the repairs would not result in unreasonable delay, particularly in view of the fact that the cargo was non-perishable. Four bids were received, (Apostles on Appeal, page 46) under which repairs were to be completed in:

- (1) 20 days
- (2) 35 days
- (3) 40 days
- (4) 48 days

On May 23, 1947, Frode accepted the bid calling for 48 days, instead of the bid calling for 20 days, and repairs were actually begun on May 26, 1947. The work had accordingly been in progress for 24 days when Frode sent its notice of purported abandonment. Frode then knew that the repairs would probably be completed in 24 more days and that the SS "Frej" could complete her voyage within a reasonable time. *The best proof that she was able to do so is, of course, the fact that she did complete her voyage.*

(c) The bills of lading gave Frode no greater right to abandon the voyage.

The notice of purported abandonment was given "under authority of applicable bills lading and otherwise." The only clause of the bills of lading which is at all applicable is Clause 4*, which provides as follows:

*A copy of the complete bill of lading was made an exhibit in the Court below and became a part of the record on appeal by stipulation and order without being printed in the Apostles. The quotation from Clause 4 found in the petition for limitation of liability (Apostles on Appeal, p. 5) is neither complete nor correct.

“In any situation whatsoever and wheresoever occurring and whether existing or anticipated before commencement of or during the voyage, which in the judgment of the Carrier or the Master is likely to give rise to risk of capture, seizure, detention, damage, delay or disadvantage to or loss of the ship or any part of her cargo, to make it unsafe, imprudent, or unlawful for any reason to commence or proceed on or continue the voyage or to enter or discharge the goods at the port of discharge, or to give rise to delay or difficulty in arriving, discharging at or leaving the port of discharge or the usual or agreed place of discharge in such port, the Carrier may before loading or before the commencement of the voyage, require the shipper or other person entitled thereto to take delivery of the goods at port of shipment and upon failure to do so, may warehouse the goods at the risk and expense of the goods; or the Carrier or the Master, whether or not proceeding toward or entering or attempting to enter the port of discharge or reaching or attempting to reach the usual place of discharge therein or attempting to discharge the goods there, may discharge the goods into depot, lazaretto, craft, or other place; or the ship may proceed or return, directly or indirectly, to or stop at any port or place whatsoever as the Master or the Carrier may consider safe or advisable under the circumstances, and discharge the goods, or any part thereof, at any such port or place; or the Carrier or the Master may retain the cargo on board until the return trip or until such time as the Carrier or the Master thinks advisable and discharge the goods at any place whatsoever as herein provided; or the Carrier or the Master

may discharge and forward the goods by any means, rail, water, land, or air at the risk and expense of the goods. The Carrier or the Master is not required to give notice of discharge of the goods or the forwarding thereof as herein provided. When the goods are discharged from the ship, as herein provided, they shall be at their own risk and expense; such discharge shall constitute complete delivery and performance under this contract and the Carrier shall be freed from any further responsibility. For any services rendered to the goods as hereinabove provided, the Carrier shall be entitled to a reasonable extra compensation."

That clause was twice judicially construed in recent years. In the case of *The Wildwood*, 1943 A.M.C. 320, 133 Fed. (2d) 765, this Honorable Court stated:

"Such a clause must be given a reasonable interpretation, and the discretion conferred may not be exercised in an arbitrary or unreasonable manner, nor without substantial grounds, nor will good faith alone suffice." (133 F. (2d) at p. 767.)

"This agreement as to the Carrier's discretion to abandon the voyage gives no more power of abandonment than exists in the absence of clause 4." 133 F. (2d) at p. 767.) (Italics added.)

Thus, the Carrier can do no more, under Clause 4, than it could have done without that clause. In *The Wildwood*, supra, the abandonment was upheld because the wartime dangers to the vessel had become substantially greater during the voyage than anticipated by the parties at the beginning of that voyage. In our case however, there were no dangers involved

in continuing the voyage when, on June 19, 1947, Frode purported to abandon the voyage.

The same clause again came before this Honorable Court in the case of *The Absaroka*, 1947 A.M.C. 325, 159 F. (2d) 134. The rule announced in the case of *The Wildwood*, supra, was restated and this Honorable Court held that the abandonment of the voyage found "justification in the increased likelihood of submarine attack" (159 F. (2d) at p. 137), and that "the effect of the torpedoing of the vessel was such as 'may cause' a decision that it was 'unsafe or impracticable to proceed * * *' * * * by reason of the presence of a war hazard greater than what was anticipated. * * *" (159 F. (2d) at p. 135.)

The abandonment was also held to have been justified on the ground that the war would unreasonably delay repairs to the ship. In that connection this Honorable Court stated: "While under ordinary conditions the time for the *Absaroka's* repairs would take about 45 days, it was a rational anticipation of the appellant's manager that without a special government priority the vessel would be 'likely' not to be repaired for months." (159 F. (2d) at p. 136.) In our case, however, there was no danger of seizure, no danger of submarine attack, no uncertainty as to when the repairs would be completed; in fact none of the conditions which might have justified Frode in abandoning the voyage were present on June 19, 1947, when the notice was given.

Under the test of reasonableness announced in *The Wildwood*, supra, and *The Absaroka*, supra, Frode

had no choice but to complete the voyage of the S. S. "Frej."

To summarize: The voyage of a vessel may be abandoned only if:

- (1) The vessel becomes a total loss, or
- (2) The vessel becomes a constructive total loss, or
- (3) The voyage is frustrated as it was in the case of *The Wildwood* and of *The Absaroka*.

None of these contingencies occurred in this case and the values for limitation purposes should accordingly be taken as of September 18, 1947, the date of the completion of the voyage in Cuba.

- (d) Since Frode had no right to abandon the voyage in San Francisco, the purported abandonment was an unlawful act which cannot fix the date as of which the limitation fund is to be determined.

A limitation of liability proceeding is "equitable in its nature." *Hartford Accident & Indemnity Co. v. Southern Pacific Co.*, 273 U. S. 207, 47 S. Ct. 357, 71 L. ed. 612; *Rice Growers v. Rederiaktiebolaget Frode*, 171 Fed. (2d) 662.

The use of equitable powers in a limitation proceeding is shown by *The Salvore* (C.C.A. 2, 1929), 1930 A.M.C. 23, 36 F. (2d) 712. Before the filing of a petition for limitation of liability by the owner of the "Salvore," a libel *in personam* had been filed by a cargo owner, and a ship other than the "Salvore" had been seized under a writ of foreign attachment. The shipowner thereafter sued the cargo owner in Italy

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for unlawful attachment and then petitioned for limitation of liability in New York, where the original libel had been filed, and obtained an injunction. The cargo owner moved that the shipowner be required to dismiss the Italian action, or in the alternative, that the injunction in the limitation proceeding be dissolved.

The Circuit Court of Appeals ordered the District Court to dissolve the injunction, unless the shipowner stayed the trial of the Italian action until the determination of the cargo owner's claim.

The Court stated:

"The limitation proceeding was an appeal to a court of admiralty, which is a court of equity, invoking the aid of the court, and the appellee, seeking equity, should willingly do equity * * *"
(36 F. (2d) at 713.)

"The court below having obtained prior jurisdiction of the parties, and the appellee having sought that same jurisdiction in its limitation proceedings, unquestionably gave the court the power to deal with the appellee before it as equity and justice required." (36 F. (2d) at p. 714.)

Thus, the Court imposed upon the party seeking the benefit of the limitation of liability statute the equitable condition that that party do equity before he could receive equity.

It must be remembered that this limitation of liability proceeding was initiated by Frode, not by Rice Growers, and that Frode is the party who seeks equitable relief. This Honorable Court should accordingly inquire, and the trial Court should have in-

quired, whether the conduct of Frode is such as to entitle it to the aid of a Court.

Frode abandoned the voyage without justification. Its only purpose was to be able to carry another cargo and thereby pocket \$200,000 instead of the \$100,000 which it had already received from Rice Growers for the same voyage.

Thus Frode comes before this Honorable Court, having deliberately breached its contract, and asks that it be allowed to take advantage of that deliberate wrong. As a court of equity, this Honorable Court should either deny Frode the right to invoke the limitation of liability statute and the benefits attached thereto or allow Frode to seek limitation *only* upon the condition that Frode do equity by posting a bond based upon the value of the "Frej" at the lawful end of her voyage in Havana.

(2) SPECIFICATION OF ERROR 9.

"9. Assuming that the Court was justified in fixing the amount of the limitation of liability fund as of a date earlier than the date of the end of the voyage (September 18, 1947), the Court erred in adopting June 19, 1947, as such date, instead of August 4, 1947, the date as of which said Rederiaktiebolaget Frode became entitled to claim the benefits of the limitation of liability statute (46 U.S.C., Sec. 181-195) by posting its ad interim stipulation for value."

We have heretofore established that:

(1) The limitation fund must be determined as of the end of the voyage, and

(2) Short of destination, there can be an end to a voyage only if:

- (a) The vessel became a total loss, or
- (b) The vessel became a constructive total loss, or
- (c) The voyage was frustrated within the meaning of *The Wildwood* and *The Absaroka*.

Our position, throughout this brief, has accordingly been that, short of destination, a shipowner can invoke the limitation statute only in the event that one of the foregoing contingencies occurred, or by posting security based upon values at the end of the voyage.

Should the rule now be announced for the first time, however, that a shipowner *can* invoke the limitation statute and post security based on values short of destination, even though none of the foregoing contingencies occurred, the only possible date as of which the limitation fund can then be fixed is the date as of which the shipowner made his election to invoke the statute. In this case, that date is August 4, 1947, the date on which Frode took the essential and irrevocable step of posting the security required by the statute.

(3) SPECIFICATION OF ERROR 3.

“3. The Court erred in holding that for the purpose of said limitation of liability fund the value of the pending freight of said Steamship ‘Frej’ was to be fixed at Ninety-three Thousand One Hundred Four (\$93,104.00) Dollars.”

Frode must also surrender the freight collected by the SS "Frej" for her voyage to Havana. It is settled that the amount to be surrendered is the gross freight, without deduction for the expenses of earning it. *The Jane Grey*, 99 Fed. 582; *The Steel Inventor*, 1929 A.M.C. 1610, 36 F. (2d) 399; *In re W. E. Hedger Co.*, 1932 A.M.C. 1064, 59 F. (2d) 982.

In *The Jane Grey*, supra, the shipowners squarely presented the question "as to their right to subtract from the freight then pending the amount of their expenditures in sending the vessel on her voyage". (99 Fed. at p. 592.) Among other items, they sought to deduct "money paid to stevedores for stowing the cargo". (99 Fed. at p. 592.)

The Court held that such deduction could not be made and that the "money paid to stevedores for stowing the cargo" was a part of the pending freight for limitation of liability purposes. The Court emphasized that, if those handling charges were not surrendered, the shipowners

"might with equal propriety subtract all their other expenses connected with the purchase and fitting out of the vessel, and commissions paid to soliciting agents for inducing passengers to purchase tickets. * * * they might as well include the value of the sails, rigging, anchors, cable, and hull of the ship. * * * The owner is required to suffer the entire loss of all that he has invested in the ship and on account of the voyage, and all that he has received for freight and passage money, * * *". (99 Fed. at p. 592.)

It is clear, therefore, that in this case the limitation fund must include not only the amount designated in the "Stipulation Re Value" as "ocean freight" (\$93,104.00), but also the amounts paid to stevedores both in San Francisco and in Havana and designated as "Handling Chgs. at San Francisco" (\$2,024.01) and "Havana Handling Fee" (\$5,060.03). It is also clear that the amounts designated in the "Stipulation Re Value" as "Manifest Fee" (\$18.00) and "Wharfage at San Francisco" (\$1,770.99) are to be considered as expenses of earning the freight and accordingly are also to be included in the limitation fund.

To summarize: Rice Growers paid to Frode a total of \$101,977.03 as the cost of carrying the rice to Cuba. That amount, and not \$93,104.00, represents the earnings of Frode for the voyage from San Francisco to Havana, the amount which Frode is required to surrender as part of the limitation fund.

CONCLUSION.

The limitation of liability fund should accordingly be fixed as of September 18, 1947, at Havana, and should include the following:

(1) The value of the SS "Frej" at the end of her voyage (Havana) . .	\$275,000.00
(2) The value of her stores at the end of her voyage (Havana)	16,005.00
(3) The freight for her voyage	101,977.03
or a total of	\$392,982.03

Frode should now be required to post a bond in that amount.

Dated, San Francisco, California,
March 2, 1949.

Respectfully submitted,

GEORGE H. HAUERKEN,

HAUERKEN & ST. CLAIR,

Proctors for Appellant.

No. 12,074

IN THE
United States Court of Appeals
For the Ninth Circuit

RICE GROWERS ASSOCIATION OF CALI-
FORNIA (a corporation),

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
"Frej",

Appellee.

BRIEF FOR APPELLEE.

FILED

APR - 1 1949

CLARENCE G. MORSE,
GRAHAM & MORSE,

310 Sansome Street, San Francisco 4, California,

Proctors for Appellee.

PAUL P. O'BRIEN,

CLERK

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ration), Owner of the Steamship
"Frej",

Appellee.

BRIEF FOR APPELLEE.

STATEMENT OF THE CASE.

Solely because of the quantity of argumentative matter included in appellant's statement of the case, appellee finds it necessary to present the following statement of the case.

At 8:30 P. M. May 6, 1947, the SS "Frej", owned and operated by appellee, Rederiaktiebolaget Frode¹, a Swedish corporation, cast off from Pier 45-C at San Francisco en route to Havana, Cuba, having on board approximately 5060 tons of rice shipped by

¹Appellee Rederiaktiebolaget Frode is hereinafter referred to as "Frode".

Rice Growers Association of California², appellant herein, to various consignees in Havana, Cuba, under eighteen separate order notify bills of lading.

At approximately 8:50 P. M. May 6, 1947, a fire broke out in the vessel's boiler room. The fire, which caused extensive damage, was combated by the crew of the SS "Frej" with assistance from various tugs and other craft, until the early forenoon of May 7, 1947, by which time the fire was extinguished.

The vessel was towed to shallow water to avoid her sinking in deep water, and at 11:30 P. M. May 6, 1947, the vessel was anchored in 23 feet of water about one-half mile southeast of Southampton Shoals to avoid loss of the vessel. After extinguishing the fire the vessel was in fact resting on the bottom and all efforts to refloat it failed until a quantity of water had been pumped out, after which the vessel was refloated at approximately 10:00 P. M. May 7, 1947, with the assistance of several tugboats.

At 1:15 A. M. May 8, 1947, the SS "Frej" returned to San Francisco and was moored at Pier 45-A. Thereafter, with the consent of all parties, the *entire cargo was unladen*, and nearly 40% of the cargo was retained and disposed of in the San Francisco Bay region, having been damaged by water, smoke and fire.

The discharge of the cargo was completed on May 14, 1947. As promptly thereafter as possible specifications for repairs were prepared and bids were taken

²Rice Growers Association of California, appellant herein, is hereinafter referred to as "Rice Growers".

thereon (Apostles on Appeal pp. 46-47); the lowest bid, that of General Engineering & Dry Dock Company, was accepted by Frode, and the vessel was taken to the repair yard of General Engineering & Dry Dock Company at Alameda, California, on or about May 23, 1947.

On June 6, 1947, Rice Growers, appellant herein, filed a libel in the District Court of the United States for the Northern District of California, Southern Division, for recovery of damages in the amount of \$365,990. The libel prayed that the SS "Frej" be condemned and sold to satisfy Rice Growers' claim. Pursuant to the libel, in rem process issued, and the SS "Frej" was seized and reduced to the possession of the United States Marshal.

On June 25, 1947, two crew members, Jakko Olavi Eriksson and Hamalainen, libeled the SS "Frej" for damages, wages, etc., said to have resulted during said voyage, in the amount of \$8,837.14.

On June 19, 1947, Frode abandoned the voyage and so notified all receivers and shippers of the rice cargo, including Rice Growers, appellant herein (Exhibit "B", Apostles on Appeal, p. 51).

On July 17, 1947, Rice Growers, appellant herein, amended its libel to include additional claims in the amount of \$100,000.

On July 25, 1947, Frode filed petition for exoneration from or limitation of liability as owners of the SS "Frej" (Apostles on Appeal p. 2).

On July 26, 1947, Frode and Rice Growers entered into an agreement (Apostles on Appeal, Exhibit "C", p. 51), which, for the mutual benefit of all parties and without prejudice, compromised certain claims in dispute. In essence, the terms of the agreement made it possible for Frode to secure the release of the vessel, in return for which Rice Growers received an undertaking to transport approximately 3200 tons of sound rice to Havana.

Frode did not by this agreement or otherwise rescind the abandonment of the voyage effected on June 19, 1947, nor did it in any way or at any time consent to transport the sound rice to Havana other than under a new and independent arrangement, as set forth in the agreement of July 26, 1947, even though for convenience said agreement of July 26, 1947, provided that the new transportation should be under the "terms" of the original bills of lading, and no inference that the abandonment of the voyage on June 19, 1947, was withdrawn or rescinded may be drawn from the fact that pursuant to said agreement, the SS "Frej" proceeded to Havana and reloaded and transported said sound rice to Havana.

Paragraph six of said agreement of July 26, 1947 (Exhibit "C", Apostles on Appeal, p. 52) provides:

"The carrying on of the cargo and/or this agreement shall in no way prejudice any right or rights which either party now has and *shall not affect the status quo of the purported abandonment of the voyage at San Francisco, California.*"³

³Emphasis supplied unless otherwise noted.

On August 1, 1947, the Shipowners & Merchants Towboat Co., Ltd. and Shipowners & Merchants Tugboat Company filed a libel in connection with the salvage services rendered to the SS "Frej" during and after the fire in the amount of \$50,000.

For the purpose of fixing the amount of the limitation of liability fund the parties have stipulated to the following values:

	<u>Vessel</u>	<u>Stores</u>	<u>Freight</u>
			Aggregate bill of lading charges total \$101,977.03, which included the following items:
May 6, 1947.....	\$255,000	\$16,845	Ocean freight .....\$93,104.00
(Prior to fire)			Havana handling fee..... 5,060.03
			Manifest fee 18.00
			Handling chgs at San Francisco 2,024.01
			Wharfage at San Francisco 1,770.99
May 8, 1947.....	106,000	8,329	" " "
June 19, 1947.....	117,000	3,000	" " "
Aug. 4, 1947.....	275,000	21,825	" " "
Sept. 18, 1947.....	275,000	16,005	" " "

This appeal puts in question the amount of the limitation of liability fund. By reason of the stipulation of values entered into by the parties (Apostles on Appeal p. 45 at p. 50), the appellant's nine assignments of error raise only two questions. The first question which is presented by assignments of error 1, 2, 4, 5, 6, 7, 8 and 9 (Apostles on Appeal p. 57) is whether the District Court erred in fixing the value of the vessel and its freight as of June 19, 1947, the

date on which appellee Frode abandoned the voyage. The second question which is raised by appellant's assignment of error number 3 (and also collaterally by catch-all assignment or error number 5) is whether the District Court erred in refusing to include in the limitation fund certain accessorial or port charges in addition to the freight.

ARGUMENT.

Appellee's argument will be presented in two parts. The first part will treat the question of the time for fixing the value of the limitation fund. The second part will treat the question of items includible in "freight for the voyage."

PART I.

SUMMARY.

The value of the ship and pending freight must be fixed as of the end of the voyage. The voyage of the SS. "Frej" ended on June 19, 1947, when the voyage was abandoned by Frode, the shipowner and appellee herein.

For limitation of liability purposes the values must be taken at the end of the voyage. The "Frej's" voyage was ended by the abandonment on June 19, 1947, regardless of whether or not there was a frustration of the voyage. Even though not relevant to the issues properly presented by the appeal, the SS "Frej"

was a constructive total loss following the fire on May 6-7, 1947, and this, with other stated circumstances, properly caused the voyage to be deemed frustrated at the time of the abandonment on June 19, 1947.

(A) FOR LIMITATION OF LIABILITY PURPOSES THE VESSEL MUST BE VALUED AT THE END OF THE VOYAGE. THE VOYAGE IN QUESTION ENDED ON JUNE 19, 1947.

The value of the vessel and its pending freight for the purpose of determining the amount of the limitation of liability fund must be established as of the end of the voyage. This rule is not questioned by either appellant Rice Growers or appellee Frode and is clearly supported by the cases.

Place v. Norwich & N. Y. Transportation Co.,
118 U.S. 468, 30 L. Ed. 134;

The Great Western, 118 U.S. 520, 30 L. Ed. 156
(1885);

Pacific Coast Co. v. Reynolds, 114 Fed. 877 (9
CCA 1902);

Boston Marine Insurance Co. v. The Metropolitan Redwood Lumber Co. et al., 197 Fed.
703 (9 CCA 1912).

The only question presented by appellant Rice Growers' specifications of error 1, 2, 4, 5, 6, 7, 8 and 9 is whether the District Court erred in finding that the limitation fund should be valued as of June 19, 1947, the date that the voyage was abandoned.

The cargo shipped by the appellant Rice Growers was the only cargo on board the SS "Frej" during

the voyage in question, which began at San Francisco on May 6, 1947. This voyage was unequivocally terminated and abandoned by appellee Frode on June 19, 1947, on which date notice of the termination and abandonment of the voyage was sent to all shippers and receivers of the cargo (Exhibit "B", Apostles on Appeal, p. 51).

It is Frode's position that the circumstances of the case were such as to justify Frode in abandoning the voyage under the general maritime law and the provisions of its bills of lading, but that whether or not, under the several contracts of carriage, the abandonment was or was not justified, the unequivocal abandonment of the voyage by Frode did in fact end the voyage on June 19, 1947, as of which date the vessel and its pending freight must be valued for the purpose of establishing the amount of the limitation of liability fund.

At no time did Frode rescind the abandonment of the voyage or elect to continue the voyage. The fact that the "Frej" later proceeded to Havana under an entirely separate and independent agreement dated July 26, 1947 (Exhibit "C", Apostles on Appeal, p. 51) despite the numerous references thereto in appellant's opening brief, furnishes no basis whatsoever for appellant Rice Growers' contention that the voyage of the "Frej", which began on May 6, 1947, continued until the arrival and discharge of the vessel at Havana. The arguments of Rice Growers in that respect are directly contrary to the agreed stipulation of facts. The ultimate transportation of the sound rice

cargo to Havana by the "Frej" was solely pursuant to the new agreement entered into on July 26, 1947, and did not in any way constitute a reinstatement of the original voyage which began at San Francisco May 6, 1947 and terminated at San Francisco on June 19, 1947.

Quoted below are respectively the applicable provisions of the agreement of on-carriage and of the Stipulation Re Value.

"6. The carrying on of the cargo and/or this agreement shall in no way prejudice any right or rights which either party now has and shall not affect the present status quo of the purported abandonment of the voyage at San Francisco, California." (Exhibit "C", Apostles on Appeal, p. 52.)

"12. Pursuant to said agreement (Exhibit "C") and between August 4 and August 8, 1947, the said about 3232 tons of rice formerly loaded in holds 1, 2, 4 and 5 were reloaded on the ship at San Francisco. On August 11, 1947, the ship sailed from San Francisco for Havana with only said 3232 tons of rice cargo aboard, and she arrived at Havana on August 31, 1947, and completed discharge of said 3232 tons on September 18, 1947." (Apostles on Appeal p. 49.)

(B) THE VALUE OF THE "FREJ" FOR LIMITATION OF LIABILITY PURPOSES MUST BE FIXED AS OF THE ABANDONMENT OF THE VOYAGE ON JUNE 19, 1947, WITHOUT REGARD TO POSSIBLE COLLATERAL CONTRACTUAL LIABILITIES.

The amount of the limitation of liability fund, which is the subject matter of this appeal, concerns a right of appellee Frode which is solely and exclusively statutory in nature and which is determined solely by the provisions of Title 46 USCA Section 185:

"Section 185. Petition for limitation of liability; deposit of value of interest in court; transfer of interest to trustee.

"The vessel owner, within six months after a claimant shall have given to or filed with such owner written notice of claim, may petition a district court of the United States of competent jurisdiction for limitation of liability within the provisions of this chapter and the owner (a) shall deposit with the court, for the benefit of claimants, a sum equal to the amount or value of the interest of such owner in the vessel and freight, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title, or (b) at his option shall transfer, for the benefit of claimants, to a trustee to be appointed by the court his interest in the vessel and freight, together with such sums, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title. Upon compliance with the requirements of this section all claims and proceedings against the owner with respect to the matter in question shall cease."

Although appellant Rice Growers devotes a major portion of its opening brief to the assertion of various theories and doctrines of the law of contracts, it is apparent and has long been recognized by the courts of the United States that the right to limitation of liability and the various incidents thereto are exclusively statutory in nature.

“The right of a shipowner in the United States to limit his liability is wholly statutory, and any proceedings for limitation are governed entirely by the statutory provisions creating such a right.”

The Maine, 28 Fed. Supp. 578 at 582.

The rule that the “voyage” should be the unit for limitation of liability purposes was accepted by our courts as a necessary inference from the applicable statutes and is the only practicable rule affording needed certainty and consistency in such cases.

Place v. Norwich & N. Y. Transportation Co.,
118 U.S. 468, 30 L. Ed. 134.

Whether the voyage is terminated rightfully or wrongfully or whether the termination of the voyage constitutes a breach of contract as to some persons are matters of no moment in so far as determining the end of the voyage for limitation of liability purposes is concerned. In applying the limitation of liability statutes the only pertinent inquiry is, “When did the voyage end?”

That the shipowner always has it in his power to terminate the voyage is recognized by the courts and is ably discussed in *The Lara*, 1947 AMC 27 (U.S. District Court, Southern District of New York), in

which the vessel, being on a voyage from New York to Barranquilla, Colombia, was involved in a collision off the coast of North Carolina on February 26, 1942. It put into Charleston for inspection, then proceeded to Tampa, where she was drydocked and repairs in the amount of \$46,500 were effected. After the completion of the repairs she proceeded on her voyage, arriving at her original port of destination, Barranquilla, Colombia, on April 9, 1942. In this case the confirmed report of the commissioner of the United States District Court correctly held as follows:

“After the collision and before the termination of the voyage, the damages caused to the *Lara* by reason of the collision with the *Cassimir* were repaired and expenses incurred in connection therewith by the owner of the *Lara* in the sum of \$46,337.49 so that at the termination of the voyage, the vessel was in a fully repaired condition. Petitioners contend that this sum should be deducted from any amount found to be the value of the *Lara* at the termination of the voyage.

“It is well established that the value of the ship to be surrendered by an owner in a limitation proceeding is her value at the end of the voyage on which she was engaged at the time of the happening of the casualty or casualties. *City of Norwich*, 118 U.S. 468, *The Great Western*, 118 U.S. 520. The place of termination of a voyage may vary. *In this case the owner could have terminated the voyage at Charleston, South Carolina or at Tampa, Florida, before making any repair at either place and the value of the interest of the owner of limitation of liability purposes*

would then have been the value of the vessel in her damaged condition at either place. However, the owner elected to make repairs, and continue the voyage and upon completion thereof to file its petition for limitation. It recognizes the value it is to file is the value at the end of the voyage. Its petition refers to all claims arising out of the voyage, whether out of the collision itself or prior thereto or thereafter. If an owner elects to continue the voyage at the risk of damage-claimant's security and thereafter ask for limitation of liability as to all claims occurring on the voyage whether at the time of the collision, prior to or subsequent, up to the termination of the voyage, he cannot expect the value to be fixed at a sum other than her value in the condition she is upon her arrival at the port *where the owner elects to terminate the voyage.*"

The Lara, 1947 AMC 27.

The "voyage" for limitation of liability purposes was carefully considered by the Circuit Court of Appeals for the second Circuit in *La Bourgogne*, 139 Fed. 433 at 436, in which the court said:

"In determining precisely what such adventure is under this statute, we concur with the District Judge in the conclusion that *the controlling circumstances are not to be found in the shipowner's agreements with individual shippers*, nor in the length of time for which a crew may be hired or the ship provisioned; nor is it important what nomenclature may be adopted in the shipowner's logbook or in the daily talk of its officers, nor how he keeps his accounts, nor how often the ship is inspected. The fundamental question seems to

be this: Considering the merchandise and passengers which are shipped as a whole, when does a ship reach a port where such merchandise and passengers are no longer any part of them exposed to the risks of transport by that ship?"

The sole question before this honorable Court on this phase of the appeal is, "When did the voyage end?" Certain ludicrous and impossible results necessarily follow if Frode's unequivocal abandonment and termination of the voyage on June 19 be deemed ineffective to "end the voyage." On one hypothesis, i. e., that if the SS "Frej" after leaving San Francisco for Havana on August 11, 1947 had sunk and become a total loss, with a total loss of all cargo on board, the amount of the limitation fund for all claims arising between May 6 and the loss of the vessel would be only the amount of the freight pending at the time of the loss of the vessel, in spite of Frode's termination of the voyage on June 19, 1947 and consistent and unmodified refusal thereafter to continue the original voyage. In such a situation Rice Growers would be the first to maintain that the voyage had ended on June 19.

By reason of the stipulation contained in paragraph "6" of the agreement of July 26, 1947 (Exhibit "C", Apostles on Appeal p. 51), the fact that the SS "Frej" proceeded to Havana with rice cargo belonging to appellant Rice Growers on board may not be considered any more a reinstatement of the original voyage than if on August 11 the SS "Frej" had sailed from San Francisco to Singapore with an entirely new

cargo on board. In such a situation under appellant Rice Growers' premise that the termination of the voyage on June 19, 1947, did not "end the voyage," and that the voyage could end only with the arrival of the SS "Frej" at Havana, the "Frej" would find herself in the interesting but somewhat implausible legal situation of possibly sailing the seven years for as many years as the Flying Dutchman without ever "ending the voyage" which it began at San Francisco on May 6, 1947.

There is no act or happening that more clearly terminates a voyage than the abandonment thereof by the shipowner. After abandonment of the voyage by the shipowner, the cargo is free to obtain on-carriage by other conveyances. If the abandonment is proper, the cargo interests normally have no recourse against the shipowner; on the other hand, if the abandonment is unjustified, the shipowner must answer to the cargo interests for breach of contract. In either event, the voyage is ended by the abandonment. Appellant Rice Growers admit that the voyage was abandoned on June 19, 1947 (appellant's Opening Brief p. 22), but then assert with but scant regard for consistency that the abandonment of the voyage did not "end the voyage" because the voyage was abandoned "without justification." The "voyage" furnishes a convenient and practical unit for limitation of liability purposes, and it is respectfully submitted that a court is not required to inquire into the multitude of contracts measured by the voyage to which every vessel is party, including contracts for

insurance, crew, officers, cargo and passengers, to determine whether, under the terms of any of such contracts, possibly a somewhat different provision for the "end of the voyage" was contemplated.

La Bourgogne, 139 F. 433 at 436 (quoted *supra*).

The United States limitation of liability statutes were enacted "to promote the building of ships and to encourage persons engaged in the business of Navigation."

Moore v. American Transportation Co. (1860), 65 U.S. 1, 16 L. Ed. 674.

The courts of the United States, in applying and construing the limitation of liability statutes, have, in keeping with the underlying purpose of such statutes, consistently so construed and applied them as to permit the vessel to remain in the custody of the owner available for commercial maritime employment *and to provide an incentive for the owner to repair the vessel* and return the vessel to profitable and economic employment as soon as practicable. This policy is aptly demonstrated by the refusal of the courts to include the proceeds of marine hull insurance in the limitation fund.

"The benefit of the statute may be obtained either by abandoning the vessel to the creditors or persons injured or by having her appraisalment made and paying the money into court or giving a stipulation in lieu of it and keeping the vessel. This double remedy given by our statutes is a great convenience to all parties. *It does not make two measures or standards of liability; for the*

measure is the same whichever course is adopted; but it enables the owner to lay out money in recovering and repairing the ship without increasing the burden to which he is subjected."

Place v. Norwich & N. Y. Transportation Co.,
118 U.S. 468, 30 L. Ed. 134.

Any ruling of the sort contended for by appellant Rice Growers as to the time for fixing the amount of the limitation of liability fund would be utterly inconsistent with the rule stated above. The arguments urged by appellant Rice Growers are utterly inconsistent with the clearly enunciated policy of the courts of the United States in applying the limitation of liability statutes so as to permit the owner to repair the vessel and return it to useful employment as promptly as possible. It is respectfully submitted that under any of the arguments advanced by appellant Rice Growers, the only economic incentive operating on any shipowner would be to exercise its right to surrender the vessel as promptly as possible after the casualty to a trustee under Title 46 USCA Sec. 185. If the argument asserted by appellant were law, no shipowner would ever expend some 150% of the value of the wreck in effecting repairs, as did Frode in this case.

Under Title 46 USCA Sec. 185, the shipowner is clearly entitled to surrender the vessel to a trustee at any time within six months after receiving notice of claim, thereby terminating any voyage that the vessel may be on. The statute itself recognizes that the end of the voyage is to be determined without

regard to the multitude of contractual questions raised by appellant Rice Growers.

“185. The vessel owner, within six months after a claimant shall have given to or filed with such owner written notice of claim, may petition a district court of the United States of competent jurisdiction for limitation of liability within the provisions of this chapter and the owner * * * or (b) *at his option shall transfer, for the benefit of claimants, to a trustee to be appointed by the court his interest in the vessel and freight* * * *.”

The above quoted statutory provision clearly recognizes the right of the shipowner to terminate the voyage at any time the shipowner may elect within the six month statutory period and that for limitation of liability purposes the shipowner may end the voyage by abandonment without regard to collateral questions under the law of contracts.

The appellant Rice Growers advances the argument that under equitable principles the abandonment of the voyage by the shipowner on June 19, 1947, must be deemed to be completely ineffective and the voyage must be considered to have ended only when the vessel completed unloading at Havana on September 18, 1947. It is respectfully submitted that the “end of the voyage” is a fact certain which was definitely established by the unequivocal action of the appellee Frode on June 19, 1947. It may be noted in passing, however, that appellant Rice Growers is hardly in a position “equitably” to claim that under equitable principles the abandonment of the voyage on June

19, 1947, was ineffective since it was appellant Rice Growers' own action in libeling the ship for more than three times the value of the wreck, as much as any other single factor, that made it appear to appellee Frode on June 19, 1947, in view of exchange restrictions, that the voyage could not possibly be continued.

It is the position of appellee Frode that, for the purposes of the limitation of liability statutes, the shipowner is entitled to have the value of the vessel and its pending freight determined as of the end of the voyage and that the voyage may be ended by the voluntary act of the shipowner.

Appellee Frode's action in abandoning the voyage on June 19, 1947, was neither willful nor unreasonable, but on the contrary the circumstances of the case fully justified the abandonment of the voyage on June 19, 1947, even though it is respectfully submitted that under the applicable statutes and authorities the vessel and its pending freight must be valued as of June 19, 1947, whether the abandonment be deemed justified or unjustified.

(C) ALTHOUGH IRRELEVANT FOR LIMITATION OF LIABILITY PURPOSES, APPELLEE FRODE WAS JUSTIFIED UNDER THE LAW OF CONTRACTS IN ABANDONING THE VOYAGE ON JUNE 19, 1947.

Appellant Rice Growers contends (Appellant's Opening Brief, pp. 20 and 23) that "the voyage of a vessel may be abandoned only if:

- (1) The vessel becomes a total loss, or
- (2) The vessel becomes a constructive total loss, or
- (3) The voyage is frustrated, as it was in the case of *The Wildwood* and *The Absaroka*."

The position asserted by appellant Rice Growers in the above quotation is obviously mistaken; it is patent that for limitation of liability purposes the voyage of a vessel may be abandoned and ended by its owner at any time without regard to the conditions stated by appellant Rice Growers. For the purposes of discussion, however, Frode is content to assume that the above quotation from appellant Rice Growers' opening brief properly states the conditions precedent to the abandonment of a voyage in the absence of which a vessel owner will be liable to shippers as for breach of contract under most contracts of carriage. Although appellee Frode does not believe that such questions of contractual obligations are in any way pertinent to this appeal, since appellant Rice Growers has devoted such extensive discussion to such questions, appellee Frode feels constrained to discuss the questions sufficiently to demonstrate that even under the rules asserted by appellant Rice Growers the voyage of the SS "Frej" was properly abandoned on or prior to June 19, 1947, as (1) the vessel had become a constructive total loss, and (2) the voyage was frustrated as it was in the case of *The Wildwood* and *The Absaroka*.

(1) The SS "Frej" was a constructive total loss under both the American and English rules.

Under the American rule the vessel is a constructive total loss if the cost of repairing the damage suffered by the vessel exceeds fifty per cent of the sound value of the vessel.

Jeffcott v. Aetna Insurance Co. (1942), 129 F. 2d 582 at 586.

In the instant case the SS "Frej" was clearly a constructive total loss on May 8, 1947, following the fire, as the cost of repairing the damage caused by the fire, \$167,498.99 (Stipulation Re Value, paragraph 4, Apostles on Appeal p. 47), was in excess of 65% of the sound value of the vessel, \$255,000 (Stipulation Re Value, paragraph 13, Apostles on Appeal p. 50).

Appellee Frode does not believe or contend that whether the SS "Frej" was or was not a constructive total loss following the fire is a proper consideration or relevant to the questions involved in this appeal. Appellee Frode points out that the SS "Frej" was a constructive total loss following the fire only to demonstrate that the opinion of the United States Supreme Court in the case of *The Maggie Hammond v. Morland*, 9 Wall. 435, 19 L. Ed. 722, relied upon by appellant, is completely inapplicable. Although the opinion does not reveal the value of *The Maggie Hammond*, it does appear that the repairs cost £185, 17 shillings, against which was credited £130 for yellow metal removed from the vessel in effecting the repairs. Thus it appears that the total net out of pocket cost of the repairs to *The Maggie Hammond* was £55,

17 shillings, which we must assume was only a small percentage of the total value of the vessel.

The Maggie Hammond v. Morland, 9 Wall. 435,
19 L. Ed. 772 at 777.

Appellant Rice Growers quoted at length from the opinion of Judge Collins in *Assicurazioni Generali v. SS. Bessie Morris Co.* (1892), 1 Q.B. 571. On appeal before the Court of Appeals the case was decided by Judges Esher, Bowen and Kay reported in Volume VII (N.S.), Aspinall's Reports of Maritime Cases, p. 217. Although the Court of Appeals affirmed the decision of the Queen's Bench division cited by appellant, it should be noted that Lords Kay and Bowen appear to base their opinion on the failure of the circumstances to meet the English rule for constructive total loss, and that only Lord Esher, even though expressly rejecting the applicability of the doctrine of constructive total loss to the circumstances of the case, applied in principle the English rule of constructive total loss.

In any event the portion of the opinion of Judge Collins quoted at length by appellant (Appellant's Opening Brief, pp. 14-15) would appear to be overruled by the opinion of the House of Lords in

Macbeth & Co. v. Maritime Insurance Co.
(1908), AC 144, XI Aspinall's Maritime
Cases (N.S.) 52.

The general doctrine applied in both the English and American cases is the same, i. e., that the owner is justified in treating the damage as a constructive total loss if the owners with reasonable prudence and

discretion are convinced that the vessel cannot be recovered without hazard of expense utterly disproportionate to the real value.

Arnould on Marine Insurance, 6th Ed., Sec. 1117, p. 1432.

The difference between the English and American rules is found in the fact that under the American authorities the expense has consistently been deemed disproportionate to the benefit if it appears that the expense of repairs would exceed 50% of the repaired or sound value of the vessel.

Fuller v. McCall (1794), 1 L. Ed 356;

Marcardier v. Chesapeake Insurance Co. (1814), 8 Cranch 39, 12 U.S. 39, 3 L. Ed. 481;

Jeffcott v. Aetna Insurance Co. (1942), 129 F. 2d 582.

It should also be pointed out that *even under the English common law rule, the "Frej" would be deemed a constructive total loss*, as under the English rule the shipowner is entitled to add the value of the wreck to the cost of the repairs to determine whether the cost of repairs would exceed the value of the ship when repaired, i.e., restored to its original condition.

Macbeth & Co. v. Maritime Insurance Co. (1908), AC 144, XI Aspinall's Maritime Cases (N.S.) p. 52.

If from the repaired value of the vessel, \$275,000, we deduct the cost of certain betterments which the owner effected (\$17,349.40), we have the value of the vessel in its restored condition of \$257,650.60, which amount is substantially exceeded by the cost of the

repairs, \$273,498.99 (\$167,498.99 paid under contract to the repair yard plus \$106,000, the value of the wreck). It is worthy of note that the *Macbeth* case was decided by the House of Lords, the highest tribunal of England, and that the court had before it the case upon which appellant Rice Growers relies so strongly, *Assicurazioni Generali v. SS Bessie Morris Co.*, VII Asp. Maritime Law Cases 217 (1892).

Macbeth & Co. v. Maritime Insurance Co., XI Asp. M. L. Cas., 52 at 54.

Appellant Rice Growers cites *Ellis v. Atlantic Mutual Insurance Co.*, 108 U.S. 342, 2 Sup. Court 746, 27 L. Ed. 747, as authority for "the rule that a contract for carriage of goods by sea *is not dissolved unless* the ship is so injured that the cost of her repairs would exceed her value when repaired, also prevails in the United States." (Appellant's Opening Brief p. 15.) Upon a close review of this opinion, appellee Frode is unable to find that the case supports the proposition stated by appellant. The case is authority for the proposition that a contract for carriage of goods by sea *is dissolved when* a ship is so injured that the cost of repairs would exceed her value when repaired, but this proposition is nowhere contested by appellee.

(2) The voyage of the Frej was frustrated.

Again, appellee Frode does not believe or contend that the question of whether or not the voyage of the SS "Frej" was frustrated at the time of the abandonment of the voyage on June 19, 1947, is either proper or relevant to the determination of this cause.

Solely because of the extensive arguments stated by appellant on this question, appellee Frode is constrained to show that, even though irrelevant, the voyage of the "Frej" was frustrated at the time the voyage was abandoned.

Appellee Frode believes, and asserted in the District Court, that the voyage of the "Frej" was automatically terminated by reason of the damages and stranding resulting from the fire within the rule recognized by this Honorable Court in *Boston Marine Insurance Co. v. Metropolitan Redwood Lumber Co.*, 197 F. 703 at 712, in which the voyage was deemed terminated at sea by the collision, even though the vessel remained afloat and was towed into port.

Since the voyage was automatically terminated on May 8, 1947 by the disaster, *a fortiori* the voyage was ended when formally abandoned by Frode on June 19, 1947.

The doctrine of commercial frustration is, of course, solely a doctrine of the law of contracts. All of the cases which consider commercial frustration and the right of a contracting party to abandon a venture by reason thereof are in agreement that circumstances constituting frustration are to be considered as of the time that the party claiming frustration elects to abandon the venture.

Kronprinzessin Cecelie, 244 U.S. 12, 37 S.C. 490, 61 L. Ed. 960;

The Absaroka, 1947 AMC 325, 159 F. (2d) 134;

The Wildwood, 1943 AMC 320, 133 F. (2d) 765.

On June 19, 1947, when appellee Frode abandoned the voyage of the SS "Frej", the circumstances confronting appellee convinced appellee, as they would any reasonable shipowner, that the purposes of the voyage of the "Frej" had been effectively frustrated. The "Frej" had been rendered unnavigable and completely unseaworthy by fire and stranding, so that she required repairs exceeding her value to fit her for sea. Approximately two-fifths of the cargo had been so damaged as to be unfit for on-carriage; as to this damaged rice, *which is the only cargo as to which Rice Growers is asserting claim*, the voyage was completely frustrated and admittedly ended at San Francisco prior to June 19, 1947. In addition, Rice Growers, present appellant, had arrested the vessel for some \$365,000, in the face of which appellee was unable to free the vessel and continue the voyage in view of exchange restrictions.

Rice Growers' claims as to the effect of the alleged breach of contract on the "end of the voyage" are completely irrelevant. A voyage may be frustrated and deemed abandoned even though the causes underlying the frustration constitute a breach of contract.

The Louise, 1945 AMC 363, 58 F. Sup. 445.

PART II.
SUMMARY.

The bills of lading (see Exhibit "A" attached to original Stipulation Re Value, cf. Apostles on Appeal p. 62) stated the charge for ocean freight and separately stated the charges for various accessorial services and facilities to be furnished to the cargo before the beginning of the voyage or after the end of the voyage. Where, as in this case, the several charges are separately stated and divisible, only the charge for transportation during the voyage is includable in "freight for the voyage."

**(A) ONLY EARNINGS FOR THE VOYAGE ARE INCLUDED IN
"FREIGHT FOR THE VOYAGE."**

For limitation of liability the shipowner is required to surrender only his *interest* in the vessel and its freight then pending. (46 USCA 185.)

It has long been settled that only that freight which the shipowner has earned for the voyage and is entitled to retain need be surrendered.

Pacific Coast Co. v. Reynolds, 9 CCA (1902),
114 F. 877.

Appellee Frode vehemently denies that its abandonment of the voyage was improper or in any wise constituted a breach of contract. Frode alleges that the abandonment of the voyage was in all ways proper and that hence it was entitled to retain the prepaid freight.

The inconsistency of the position of appellant Rice Growers is apparent. Appellant on the one hand argues that the abandonment was not justified under the principles considered by this honorable Court in the *Absaroka* and presumably asserts as a corollary that by abandoning the voyage on June 19, 1947, appellee Frode lost its right to retain the freight paid on the sound portion of the cargo, there being no question that the voyage was frustrated as to nearly 40% of the cargo, which was damaged and disposed of at San Francisco. Yet appellant argues that the full charges received by Frode from Rice Growers should be deemed "earned freight" for fixing the amount of the limitation of liability fund.

Ignoring the inconsistencies in appellant's position, the question in the form presented by appellant under assignment of error number 3 is whether the District Court erred in excluding charges other than freight from the computation of the limitation fund.

It is clear under the applicable statutes and authorities that "freight" for the purpose of the limitation of liability statutes includes all earnings of the *voyage* or, as stated in some cases, it is the intent of the statutes that the shipowner surrender his entire investment in the voyage, including any interest that the owner may have in the earnings of the voyage.

The Jane Grey, 99 F. 582.

It is readily admitted that, depending upon the terms of the individual contracts of carriage, some items may or may not be included in the "pending

freight” for limitation of liability purposes. For example, where the contract is for an indivisible lump sum, the entire amount will be deemed freight, even though it includes compressing and baling the cargo.

Ellis v. Atlantic Mutual Insurance Co., 108 U.S. 342, 2 S.C. 746, 27 L. Ed. 747.

(B) THE NATURE OF THE CHARGES IN QUESTION.

It is necessary to review the nature of the separately stated items that appellant claims the District Court erred in excluding from the “pending freight”.

Havana handling fee: This item represents the charges assessed against the cargo for the use of the terminal at Havana by the cargo; it does not include any costs of stevedoring in unloading or other expenses attributable to the operation of the vessel in transporting, loading or unloading the goods. It represents solely the charge assessed by the Havana terminal authorities, payable by the cargo, for receiving and delivering the cargo after the cargo has left the custody of the vessel.

Manifest fee: It is necessary that the bills of lading for all cargo entering Havana be translated into Spanish and visaed by the Cuban Consulate at San Francisco. Under Article 14 of the bills of lading, such documentation charges are for the account of the cargo, and the manifest fee of \$1.00 per bill of lading covers the cost of the necessary Cuban documentation for the cargo, which appellee performed for appellant

Rice Growers in addition to transportation of the goods. The services covered by the manifest fee were completed before the SS "Frej" began its voyage on May 6, 1947.

Handling charges at San Francisco cover the stevedoring costs from place of rest on the dock to ship's tackle. There is no element of compensation in such handling charges for the use or operation of the vessel. The amount of such handling charges covers solely an operation which was completely terminated before the cargo entered the custody of the vessel. Appellee, as exclusively the owner and operator of a vessel, was unable itself to furnish the services covered by the handling charges and therefore stated such charges separately from the freight which it was charging for carriage of the goods on the contemplated voyage.

Wharfage at San Francisco is the charge assessed by the State Board of Harbor Commissioners at San Francisco for the use which the cargo makes of the piers. This charge has no relation to the operation of the vessel and is transmitted in toto by the carrier to the port authorities. The use of facilities for which the toll is exacted is concluded at the time the goods enter the custody of the vessel and before the vessel begins its voyage.

It is apparent that none of the bill of lading charges, with the exception of "ocean freight", is includable in the *earnings* of the shipowner for the *voyage* or in freight for the use of the ship.

- (1) **None of the charges in question was for services to be performed during the voyage.**

All of the charges which appellant asserts should be included in pending freight are in the nature of "port charges," which were specifically considered by the District Court for the Southern District of New York and excluded from the amount of pending freight.

"The vessel was sailed by the master, who was not one of the owners, on half shares. The interest of the owners in the freight was one-half of the freight *after deducting port charges*, and so the Commissioner has found. Report confirmed."

In re Wright, et al., Fed. Cas. 18,066 (1878).

The several contracts of carriage involved in this appeal each clearly contemplated that the actual transportation services performed by the vessel, i.e., so-called tackle to tackle transportation, should be fully compensated for by the "ocean freight." The arrangements between the parties likewise clearly contemplated that all charges other than "ocean freight", all of which are related to services or facilities furnished to the cargo before loading and after discharge from the vessel, should be separately stated and separately charged. The only question is whether, in a situation such as the present one, where the carrier and the shipper have agreed that certain charges relating to services before the commencement of the voyage and after the termination of the voyage, shall be separately stated, such charges must, in spite of that agreement, be deemed included in the *earnings* of the *voyage*. It is respectfully submitted that such is not the case.

It is clear under 46 USCA 184, as indicative of the intent of 46 USCA 185, as well as the authorities, that the freight or earnings to be surrendered is the "freight for the *voyage*."

La Bourgogne, 139 F. 433 at 436.

"Whenever any such embezzlement, loss, or destruction is suffered * * *, and the whole value of the vessel, *and her freight for the voyage*, is not sufficient to make compensation to each of them, they shall receive compensation from the owner of the vessel in proportion to their respective losses; and for that purpose the freights and owners of the property, and the owner of the vessel, or any of them, may take the appropriate proceedings in any court, for the purpose of apportioning the sum for which the owner of the vessel may be liable among the parties entitled thereto." 46 USCA 184.

(C) WHERE, AS HERE, CHARGES OTHER THAN THOSE FOR TRANSPORTATION DURING THE VOYAGE ARE SEPARATELY STATED AND DIVISIBLE, SUCH CHARGES ARE NOT INCLUDED IN THE FRIEGHT FOR THE VOYAGE.

Although in some cases where the carriage is for an agreed lump sum indivisible freight payment, it would be proper to include the entire payment as pending freight because of the indivisible nature of the payment, in a case such as the present one, where certain services before loading and after discharge are separately stated, it is clear that such charges are not includable in "freight for the *voyage*."

It is clear from all cases which have considered the question and where the sum paid by the shipper is apportionable or divisible, that only that portion of the payment which is attributable to the ocean transportation is includable in "pending freight" for limitation of liability purposes.

In re Wright, Fed. Cas. 18,066;

Ralli v. N. Y. & T. S.S. Co., 154 F. 286.

In its opinion in *Pacific Coast Co. v. Reynolds*, this Honorable Court raised the question whether wharfage and advance charges should be deemed includable in "freight."

"It results that the item of \$3,867.47 for pre-paid freight, wharfage, and advance charges must be deducted from the amount the petitioner should be required to pay in order to secure the benefit of the statute limiting its liability, even if all of the items entering into that charge can be properly regarded as freight."

Pacific Coast Co. v. Reynolds, 114 Fed. 877 at 882.

In *Ralli v. N. Y. & T. S.S. Co.*, 154 Fed. 286 at 288, the Court of Appeals for the Second Circuit considered a situation in which a respondent had asserted the limitation of liability statutes as a defense. Respondent carrier had issued through bills of lading at Galveston for transportation of certain cargo to Ghent, Belgium, with transshipment at New York. Both the initial carrying vessel and the lighter in the New York harbor on which the damage occurred were owned by the respondent. The through freight rate from Galveston to Ghent was 37¢, of which 18¢ was

shown to be applicable to the carriage from New York to Ghent and 3¢ was shown to be the price of lightering in New York harbor. The District Court had held that the pending freight of the lighter, on which the damage occurred, was 19¢ per 100 pounds (the price of lighterage plus the cost of transportation from Galveston to New York). The Circuit Court reversed the District Court on this point and held that the "pending freight" was only the 3¢ per 100 pounds representing the cost of lightering in New York harbor, even though the lighter and the vessel which had carried the goods from Galveston to New York both belonged to the same owner.

The same case supports the rule that only freight for the *voyage* need be surrendered, and where the charges received by the carrier are divisible, only those charges attributable to the "*voyage*" need be surrendered.

Although in certain situations there may be a question as to when a voyage commences, it is clear that as to goods and cargo, the voyage does not commence until the goods are laden on board.

"We are of the opinion that respondent cannot claim the benefit of the section above quoted for the reason that the voyage had not commenced. The cargo was not yet all on board, nor the vessel ready to sail."

Ralli v. N. Y. & T. S.S. Co., 154 Fed. 286 at 287.

Similarly, the limitation of liability statute itself, 46 USCA 183, treats the lading on board of cargo as the critical act and moment for the purposes of the

statute. No limitation of liability may be had as to goods prior to their being laden on board.

“46 USCA 183. (a) The liability of the owner of any vessel whether American or foreign, for any embezzlement, loss, or destruction by any person of any property, goods or merchandise, *shipped or put on board of such vessel * * **”

Likewise it is clear that the Havana handling fee, which was for services after the end of the contemplated voyage, should not be included.

It is clear that the Havana handling fee was for services contemplated to be performed after the end of the voyage. The question of the “end of the voyage” was carefully considered in *The Pelotas*, 21 F. (2d) 236, in which limitation of liability was denied for damages sustained following the end of the voyage.

“Moreover, in contemplation of law a voyage of a vessel has been consistently recognized and defined as the sailing or passage or transit of a ship from a port of origin to a port of destination. *The voyage ends when the vessel is safely moored at a port of destination and is ready for unloading.*”

The Pelotas, 21 F. (2d) 236.

It is respectfully submitted that where, as in this situation, charges for certain services to be rendered prior to lading on board of the cargo and after unloading are separately assessed, such charges need not be surrendered under the limitation of liability statutes, particularly as the services in connection with which such charges are assessed are all completely per-

formed either prior to or subsequent to the period during which the limitation of liability statutes apply.

It is clear under the several contracts of carriage concerned in this litigation that the sums designated as "ocean freight" were intended by the parties to constitute the full payment for the contemplated "tackle to tackle" transportation of the goods by appellee. It is likewise clear under the foregoing authorities that for limitation of liability purposes in a situation of this type, the contemplated voyage is bounded and defined by the ship's tackle. This view is supported by the language of the limitation statutes themselves, the definition of "carriage of goods" contained in the United States Carriage of Goods by Sea Act, 46 USCA, Sec. 1301(e), and the foregoing authorities.

"46 USCA 1301(e). The term 'carriage of goods' covers the period from the time the goods are loaded on to the time when they are discharged from the ship."

The charges in question are not attributable to services comprised in the "voyage" but are separately stated and clearly divisible from the freight, and it is respectfully submitted that moneys received to cover disbursements for charges before the beginning and after the end of the contemplated *voyage* are not includable in "freight for the voyage." The period covered by the contracts of carriage may be greater than the period of the voyage, but it is only the *earnings* of the *voyage* that are included in the limitation fund.

La Bourgogne, 139 F. 433;

Ralli v. N. Y. & T. S.S. Co., 154 F. 286.

CONCLUSION.

It is respectfully submitted that the owner's interest in the SS "Frej" and its pending freight must be valued as of June 19, 1947, on which date the voyage was ended by abandonment even if not earlier ended by the catastrophe, and further, that only the ocean freight charge, the only charge applicable to the "voyage", is includable in freight for the voyage. Accordingly, the order of the District Court fixing the limitation of liability fund at \$213,104 should be affirmed with costs to appellee.

Dated, San Francisco, California,

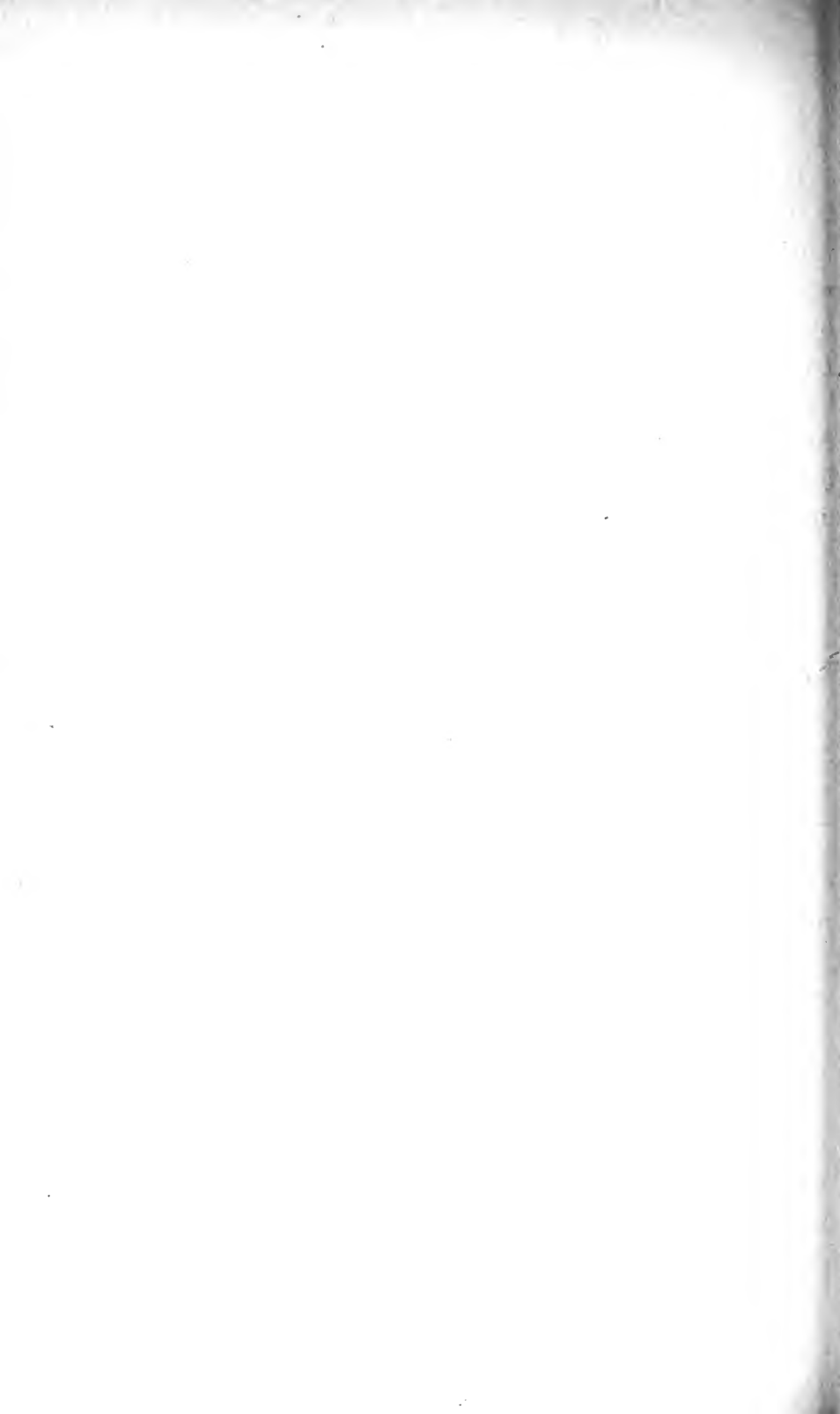
April 1, 1949.

Respectfully submitted,

CLARENCE G. MORSE,

GRAHAM & MORSE,

Proctors for Appellee.



No. 12,074

IN THE

United States Court of Appeals
For the Ninth Circuit

RICE GROWERS ASSOCIATION OF CALI-
FORNIA (a corporation),

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
"Frej",

Appellee.

APPELLANT'S REPLY BRIEF.

GEORGE H. HAUERKEN,

HAUERKEN & ST. CLAIR,

535 Russ Building, San Francisco 4, California,

Proctors for Appellant.

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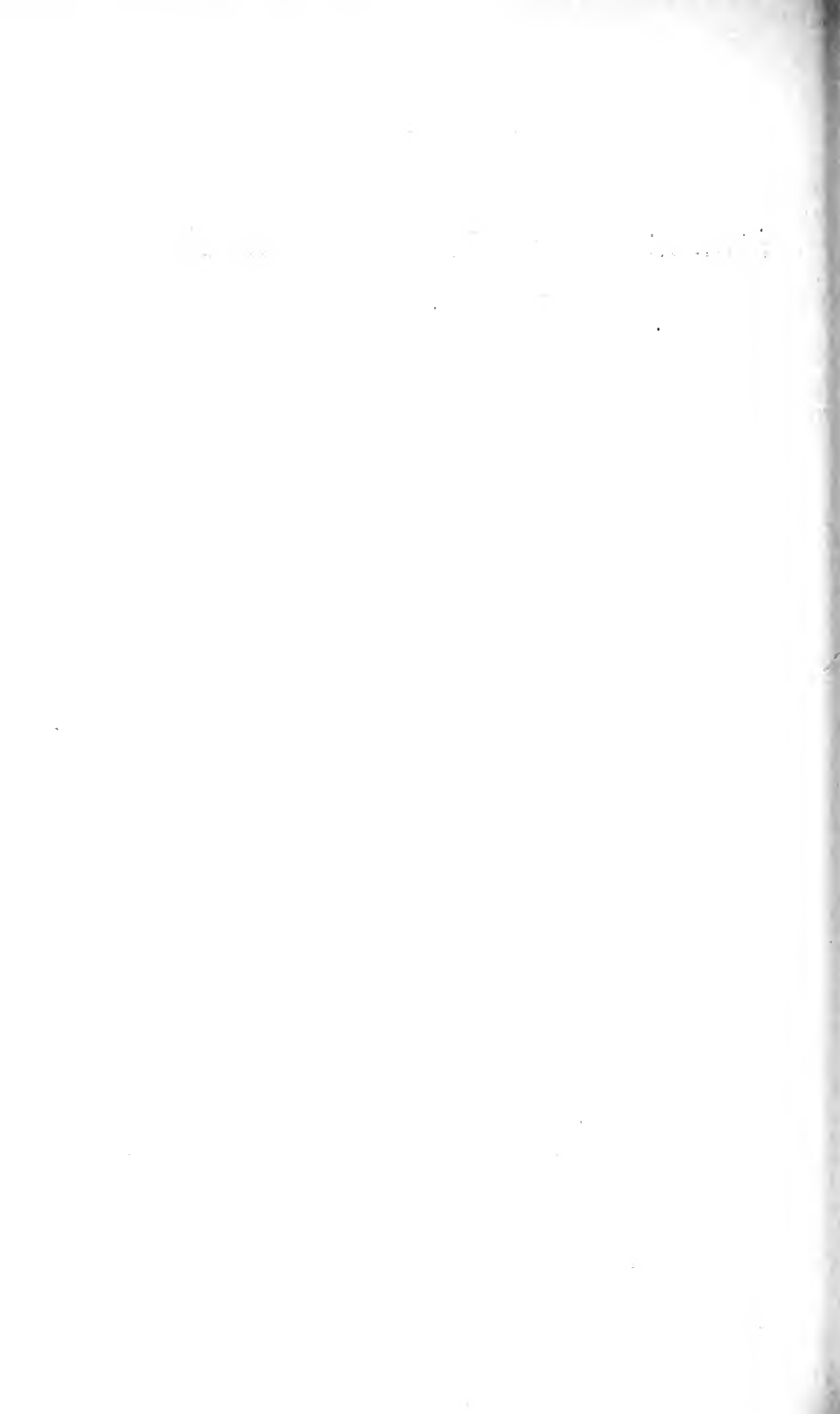
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FORNIA (a corporation),

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VS.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
"Frej",

Appellee.

APPELLANT'S REPLY BRIEF.

ARGUMENT.

PART I.

(1) THE EFFECT OF THE AGREEMENT OF JULY 26, 1947.

Frode strongly urges its rights under the agreement of July 26, 1947.¹ (Exhibit "C", Apostles On Appeal, page 52.)

Under that agreement *both* parties reserved *all* their rights. In order to determine what those rights were,

¹Paragraph 6 of that agreement reads as follows:

"6. The carrying on of the cargo and/or this agreement shall in no way prejudice any right or rights which either party now has and shall not affect the present status quo of the purported abandonment of the voyage at San Francisco, California."

the facts upon which the agreement was based should be briefly restated.

On June 6, 1947, Rice Growers filed its libel. The Frej was seized and remained in the custody of the marshal until August 9, 1947.

On June 19, 1947 (at a time when it not only was clear that the Frej was capable of being repaired, but when she was in fact undergoing repairs) Frode sent out a writing purporting to abandon the voyage.

On July 17, 1947, Rice Growers amended its libel to claim additional damages in the amount of ninety-five thousand (\$95,000.00) dollars for breach of contract by reason of the purported abandonment.

The ship and cargo were thus at loggerheads. The ship contended that it had abandoned and would not proceed on its voyage. The cargo contended that the ship could not lawfully abandon the voyage; that the ship could and should proceed to destination. This much is certain: the Frej was capable of being repaired and she was repaired within a reasonable time. She was capable of carrying her original cargo on to its original destination and she did carry it there within a reasonable time.

The effect of the agreement was that (1) the sound cargo was carried to destination by the Frej, and (2) Frode received ten thousand (\$10,000.00) dollars to which it was not entitled, and (3) Frode secured the dismissal of the cause of action for ninety-five thousand (\$95,000.00) dollars for breach of contract and (4) Rice Growers avoided the necessity of spending ninety-five thousand (\$95,000.00) dollars to forward

the sound cargo and then suing Frode to recover that amount, and (5) the payment of storage and extra handling charges at San Francisco was arranged subject to ultimate Court adjudication, and (6) each party reserved its rights and contentions against the other.

The agreement was entered into on July 26, 1947 (nine days after the filing of the action for breach of contract and one day after the filing of the limitation proceeding).

Rice Growers reserved the right to contend and does contend that Frode could not and did not in fact abandon the voyage.

We pointed out on page 21 of our opening brief that the limitation proceeding was initiated by Frode, not by Rice Growers, and that Frode is the party who seeks equitable relief. We contended then, as we contend now, that the trial Court should have inquired and that this Court should inquire as to whether the conduct of Frode is such as to entitle it to the aid of a Court. We further contended that Frode, having deliberately breached its contract, should not be allowed to take advantage of that deliberate wrong and that, as a Court of equity, this Honorable Court should either deny Frode the right to invoke the limitation of liability statute and the benefits attached thereto or allow Frode to seek limitation *only* upon the condition that Frode do equity by posting a bond based upon the value of the Frej at the lawful end of her voyage in Havana. In support of our position, we cited the following cases:

Hartford Accident & Indemnity Co. v. Southern Pacific Co., 273 U. S. 207, 47 S. Ct. 357, 71 L. ed. 612;

Rice Growers Association of California v. Rederiaktiebolaget Frode (1948), 171 Fed. (2d) 662;

The Salvore, 1930 A.M.C. 23, 36 F. (2d) 712.

Since Frode makes no reply thereto and does not discuss those cases it must be assumed that that contention cannot be answered.

Under that equitable doctrine, the notice of abandonment of June 19, 1947, should be considered as wholly without validity and force. The reservation of rights in the agreement of July 26 is only as good as the notice of abandonment of June 19, 1947, for if there was no lawful abandonment on June 19, 1947, there were no rights for Frode to reserve. Accordingly, the case must be viewed from the standpoint of what the parties did, as distinguished from what Frode said and attempted to do by its abortive notice of abandonment on June 19, 1947: since the Frej was repaired and reloaded and went on to her original destination, we have the simple case of a vessel arriving at her agreed destination (Havana) and completing her *voyage*. This is the unit or period of time for which the valuation is to be made under the limitation of liability statute. See *Place v. Norwich and New York Transportation Co.*, 118 U. S. 468, 6 S. Ct. 1150, 30 L. ed. 134.

(2) FOR LIMITATION OF LIABILITY PURPOSES THE VESSEL MUST BE VALUED AT THE LAWFUL END OF THE VOYAGE. THE VOYAGE IN QUESTION ENDED IN HAVANA ON SEPTEMBER 18, 1947.

Frode cites *The Maine*, 28 F. S. 578 for the proposition that the right of a shipowner to limit his liability is wholly statutory. Whether or not it is statutory is not the issue in this case.

Frode cites *The Lara*, 1947 A.M.C. 27, (a District Court case,) for the proposition that a ship owner can terminate a voyage prior to destination and invoke the limitation of liability statute at that time. *The Lara completed her voyage*. Some time after the completion of her voyage, limitation proceedings were instituted. Therefore, the language quoted by Frode is *obiter dictum*. It is wholly unsupported by any authority and is in fact directly contrary to the holding of the Supreme Court in the *Place* case, *supra*, and *The Maggie Hammond v. Morland*, 9 Wall. 435, 19 L. ed. 772.

The *Place* case after stating:

“The *voyage* defines the limits and boundary of the *casus*, or case, to which the law is to be applied”, (30 L. ed. at p. 143)

points out that

“And this was manifestly the maritime law, for by that law the abandonment of the ship and freight (when not lost) was the remedy of the owners to acquit themselves of liability; and, of course, *this could only be done at the termination of the voyage * * **” (30 L. ed. at p. 143) (italics added).

Predicated upon the foregoing language, the Court held that the statute contemplated only one measure of liability.

In our opening brief, we cited *The Maggie Hammond v. Morland*, 9 Wall. 435, 19 L. ed. 772, and *Assicurazioni Generali v. SS. Bessie Morris Co.* (1892) 1 Q. B. 571, as authority for the proposition that a ship owner has the *duty* to refit and repair and complete the voyage *if he can*.

Frode has simply not answered that argument. There is no answer to that argument. The ship owner does have a duty when he enters into a contract with a cargo owner and he has no more right to repudiate his contract than anyone else has.

Therefore Frode relies upon the District Court decision of *The Lara* as against the Supreme Court decisions of the *Place* case and *The Maggie Hammond* case and the English rule enunciated in the *Assicurazioni* case.

Frode has cited the Circuit Court decision in *La Bourgogne*, 139 Fed. 433, (affirmed 210 U. S. 95, 28 S. Ct. 664, 52 L. ed. 973). The *Bourgogne* was in a shuttle service between Le Havre and New York. On a trip from New York to Le Havre she collided with another ship and sank. Limitation proceedings were instituted and her owner surrendered to a trustee the sum of one hundred (\$100) dollars, the value of the articles saved from the wreck. The question arose as to what freight money should also have been surrendered. The ship contended that it should only surrender the freight for the voyage from New York to Le Havre,

whereas the claimants contended that the freight from Le Havre to New York should also be surrendered as well as an annual subsidy from the French government. The Court held in favor of the ship. If the opinion of the Circuit Court of Appeals is to be deemed to still be in effect, La Bourgogne should be cited in favor of Rice Growers and not Frode, because it holds that the *Court must look at the over-all picture in determining what the voyage actually is.*

At page 14, Frode states that if the Frej had sunk after leaving San Francisco for Havana on August 11, 1947, Rice Growers would be the first to maintain that the voyage had ended on June 19. This is no argument, but, if it calls for an answer, the answer simply is that, had the Frej sunk on her way to Havana, Frode would have been the first one to maintain that the voyage had *not* ended on June 19, but had ended by the sinking of the vessel.

Neither the Congress in enacting the limitation statute nor the Supreme Court in construing it in the *Place* case, conceived of a shipowner acting otherwise than in fulfilment of his contracts. The rule is the same in all cases whether the ship be surrendered or a bond be put up in lieu thereof. In all cases a ship either can complete her voyage and does so, or cannot complete her voyage and does not do so. If a ship completes her voyage, the surrender of the ship or the bond will be predicated upon the same time and place and the same value. If a ship cannot complete her voyage and is *legally* excused, the surrender of the ship or the bond will likewise be predicated upon the same time and place and the same value. It is only

where the ship owner deliberately breaches its contract and seeks to profit by its own wrong that two standards are attempted to be submitted to the Court. Such is the case here. Frode *could* complete the voyage and in fact *did* so, yet it contends that its bilateral agreement with Rice Growers could be terminated by unilateral action and that, as a wrongdoer who deliberately breached its contract, it can claim the benefit of the limitation statute and can place before the Court a double measure or standard of liability, although the *Place* case held that that could not be done.

Frode claims (on page 17) that it could have surrendered the ship and its freight to a trustee "thereby terminating any voyage that the vessel may be on". As we have just demonstrated, Frode wholly misconceives the statute and wholly ignores the rule of the *Place* case which makes the voyage the unit.

Courts are more impressed by what people do than by what they say. If the purported abandonment of June 19, 1947, were valid and Frode *really* thought so, why did Frode carry the original cargo on for a mere ten thousand (\$10,000.00) dollars when it could have secured another one hundred thousand (\$100,000.00) dollars for doing the same thing?

(3) THERE WAS NEITHER CONSTRUCTIVE TOTAL LOSS NOR FRUSTRATION OF THE VOYAGE.

Frode contends (page 19 to page 26, inclusive, of its brief) that it was justified in abandoning the voyage of the *Frej* on or before June 19, 1947, for the

reason that the Frej had become a constructive total loss, and that her voyage had been frustrated within the meaning of the *Wildwood* and *The Absaroka*.

In support thereof, Frode cites the following American and English *insurance* cases:

Jeffcott v. Aetna Insurance Company, 129 F. (2d) 582;

Marcardier v. The Chesapeake Insurance Co., 3 L. ed. 481;

Fuller v. McCall, 1 L. ed. 356;

Macbeth & Co., Limited v. Maritime Insurance Company, Limited (1908), A. C. 144.

In insurance cases, the Courts have prescribed a formula or percentage rule with which to determine the cases in which it would be unreasonable to require the shipowner to repair. The shipowner is not obligated to claim from his underwriter for a constructive total loss even though the damage be in excess of such percentage, but has the option to do so upon surrendering the vessel to the underwriters.

In a cargo case (between a shipowner and a cargo owner) the rule is as enunciated in *Assicurazioni Generali v. the Steamship Bessie Morris Co.* (1892), 1 Q. B. 571, that by virtue of the contract of carriage the law imposes on the shipowner the duty to proceed on his voyage whenever the expense of repairing the ship is "not greater than the value of the ship and freight when repaired sufficiently to complete the voyage". To the same effect see *The Maggie Hammond v. Morland*, 9 Wall 435, 19 L. ed. 772.

In this case, the ship was repaired and proceeded. Therefore, there was no constructive total loss. The following language from the decision of the Court of Appeal in *The Assicurazioni Generali* case demonstrates that Frode cannot contend for a constructive total loss in this case:

“Perhaps the shipowner might have been justified in treating the ship as incapable of being repaired *but he did not do so*. It is absurd to argue that the shipowner can say that he was prevented from fulfilling his contract by perils of the sea by reason of the great expense of repairing, when he did in fact repair and proceed upon a voyage. Here, therefore, the completion of the voyage was not prevented by the perils of the sea and the abandonment of the contract was unjustifiable * * *” (VII Aspinall’s Reports (N.S.) 217 at p. 219.) (Italics added.)

In this case, as in the *Assicurazioni Generali* case, the shipowner is making the “absurd” contention that it did not do and could not do what in fact it did. It is submitted that this Court should disregard that contention and hold, as the Court of Appeal held in the *Assicurazioni Generali* case, that:

“If the shipowner acts upon the view that it is possible to repair the vessel and proceed, it is then clear that it is not impossible to do so, and *it becomes absurd to discuss the question of constructive total loss* * * *” (VII Aspinall’s Reports (N.S.) 217 at p. 218.) (Italics added.)

Frode also cites the *Kronprinzessin Cecelie*, 244 U. S. 12, 13 S. Ct. 490, 61 L. ed. 960. That case, like the *Absaroka* and the *Wildwood* which were reviewed

in our opening brief involved the frustration of a voyage because of increased war perils and is accordingly completely distinguishable from our case.

Finally, Frode cites *The Louise*, 58 Fed. Sup. 445, 1945 A.M.C. 363. This was an action by cargo owners for the recovery of prepaid freight. The *Louise* sailed in unseaworthy condition and was forced to return to port for repairs thereby being guilty of a deviation. The cargo owners then promptly reshipped their cargo to avoid further loss without giving the shipowner a full opportunity to repair. The Court held that, under the circumstances of the case, the *cargo owners* were justified in assuming that the voyage had been frustrated and were accordingly entitled to recover the prepaid freight, notwithstanding the fact that the bills of lading contained a "ship lost or not lost" clause.

PART II.

The cases cited by Rice Growers hold that the gross pending freight must be surrendered, and that no deductions of any sort can be made by a shipowner for the expenses incident to earning that freight.

The Steel Inventor, 36 Fed. (2d) 399;

In re W. E. Hedger Co., Inc., 59 Fed. (2d) 982;

The Jane Grey, 99 Fed. 582.

Frode admits that pending freight (that which is earned, vessel lost or not lost), must be included in the limitation fund.

Frode seeks to distinguish its position and contends for surrender of less than the gross pending freight

by claiming that: (1) under the bills of lading only the charges for transportation are includable, (2) the period of the voyage for the purpose of determining the amount of pending freight is from ship's tackle to ship's tackle, and (3), by their nature charges other than transportation are not includable in the gross pending freight. The contentions will be discussed in order.

(1) \$101,977.03 is the gross pending freight earned for the voyage.

Bill of Lading No. 1 has on its face the following:²

					FREIGHT
1,014,250\$	@	.92¢	per 100 lbs.	\$	9,331.10
					100 LBS.
LANDING FEE	@	.05¢	per 224 LBS.	\$	507.13
MANIFEST FEE	in.	@ \$1.00 B/L	per cub. ft.	\$	1.00
					2,000#
HANDLING	in.	@ .40¢	per 100 LBS.	\$	202.85
WHARFAGE	@	.35¢ PER 2000#		\$	177.49
					\$ _____
•FREIGHT TO BE PREPAID/TO COLLECT					XXXXXXXXXX \$ 10,219.57

•(Cross out words not applicable)

All 18 bills of lading are similar. On each Frode named the total at the bottom of the column "freight to be prepaid".

By clause 15 of the bill of lading the prepaid freight is specifically made *earned*, vessel lost or not lost. Accordingly Frode admits the total of \$101,977.03 as

²"Exhibit A", Apostles on Appeal, p. 62.

freight to be prepaid and earned, vessel lost or not lost. The printed bill of lading must be interpreted most strongly against the party drawing it. The Supreme Court, in *La Bourgogne*, 210 U. S. 95, 28 S. Ct. 664, 52 L. ed. 973, dealing specifically with the amount of freight to be included in a limitation fund, stated:

“* * * In view of the decision in *The Maine v. Williams*, 152 U. S. 122, 38 L. ed. 381, 14 S. Ct. 86 * * * the duty to surrender pending freight to entitle to a limitation of liability must be liberally construed against the shipowner * * *” (52 L. ed., at p. 992).

In *The Jane Grey*, 99 Fed. at 592, it is said

“The owner is required to suffer the entire loss of all that he has invested in the ship and on account of the voyage, and all that he has received for freight and passage money, and all the ship would have earned by completing the voyage;
* * *”

In *Ellis v. Atlantic Mutual Insurance Company*, 108 U. S. 342, 2 S. Ct. 746, 27 L. ed. 747, cited by Frode,³ a shipowner libelled for freight. Though not a limitation case, the Court *included* in the amount of freight the cost of compressing and baling the cotton cargo (a charge much further removed from the “transportation” than those here in question).

In *re Wright*, Fed. case 18066 (1878), cited by Frode,⁴ was a District Court decision in 1878. No

³Appellee's Opening Brief, p. 29.

⁴Appellee's Opening Brief, pp. 31, 33.

facts are given in the reported decision from which the language quoted by Frode can be viewed in support of Frode's position. Because of the clear language supported by reported facts in later decisions *In re Wright* must be considered as overruled, or as having been decided on facts not similar to the later decisions and the litigation before this Court.

(2) The freight surrendered into the limitation fund cannot be limited by the "tackle to tackle" carriage.

Frode attempts to impose the tackle to tackle definition of the Carriage of Goods By Sea Act as the period to be used in determining the amount of freight to be surrendered. That definition has nothing to do with limitation of liability. Moreover, clause 1 of the bill of lading⁵ issued by Frode specifies that said Act "shall govern *before* the goods are loaded on and *after* they are discharged from the ship, and *throughout the entire time that the goods are in the custody of the Carrier.*" Notwithstanding this clear language Frode now, *contrary to its own contract*, attempts to prevail upon the Court for aid in not disgorging the *full freight which was earned, vessel lost or not lost*. The position is untenable, and the cases cited by Frode do not support its position.

Frode ignores the facts in *La Bourgogne*, 139 Fed. 433,⁶ and ignores the decision of the Supreme Court in the same case. Rice Growers herein distinguished the facts in *La Bourgogne*.⁷ Damage claimants con-

⁵"Exhibit A", Apostles on Appeal, p. 62.

⁶Appellee's Opening Brief, pp. 32, 36.

⁷*Supra*, p. 6.

tended that an annual subsidy, as well as passage money from New York to Le Havre and Le Havre to New York should be surrendered. It was held that only passage money from New York to Le Havre (the voyage in question) should be included.

In *Ralli v. N. Y. & T. SS. Co.*, 154 Fed. 286, relied upon by Frode,⁸ cotton was shipped from Texas to Belgium, with transshipment at New York. The lighter used to transfer the cargo at New York careened and sank, causing cargo damage. The lighter owner, in defense to the action by cargo interests, pleaded the Harter Act and sought limitation of liability. The Court considered the questions: (1) the applicability of the Harter Act, and (2) the amount of "pending freight" to make up the limitation fund, and dealt with them separately.

The language quoted by Frode⁹ is that part of the opinion expressly considering the Harter Act and merely holding that a shipowner cannot invoke the Harter Act until the vessel breaks ground. Regarding the amount of "pending freight" the Court held that limitation was sought only as owner of the lighter, that the lighter was the *vessel* in question and that only freight attributable to the lighterage could be included in the limitation fund. The question of what items made up "freight pending" was not considered.

Frode also cites *The Pelotas*, 21 Fed. (2d) 236,¹⁰ a case involving the question of whether a shipowner is

⁸Appellee's Opening Brief, pp. 33, 34, 36.

⁹Appellee's Opening Brief, p. 34.

¹⁰Appellee's Opening Brief, p. 35.

entitled to limit his liability for a collision which in fact occurred *after* the end of the voyage. The case has nothing to do with freight or limitation.

From *The Jane Grey* it is clear that it is not "the tackle to tackle carriage" which determines the amount of freight in a limitation fund and that there is no right "to subtract from the freight then pending the amount of their expenditures in sending the vessel on her voyage." (99 Fed. at 592.)

(3) By the nature of the "charges in question" they all must be included in the limitation fund.

It is necessary that the gross earnings of the SS. Frej (not merely the "net profit") from the venture be surrendered. Frode must surrender the prepaid freight which under the bills of lading was not to be returned in case the voyage was not completed. 3 *Benedict on Admiralty* 454; *The Maine v. Williams*, 152 U. S. 122, 14 S. C. 486, 38 L. ed. 381; *Pacific Coast v. Reynolds* (9 CCA), 114 F. 877.

To deal with the items specifically:

Havana handling fee: In the bill of lading this was labelled "landing fee".¹¹ Frode contends that the Havana handling fees were terminal charges payable by cargo "for receiving and delivering the cargo *after* the cargo has left the custody of the vessel".¹² There is no evidence before the Court to support this statement. It is naive to consider this item as representing

¹¹Supra, p. 12.

¹²Appellee's Opening Brief, p. 29.

anything other than charges paid by Frode incident to unloading the Frej. What handling charges could there be that the ship would pay Havana terminal authorities *after* the cargo was landed on the dock? The question answers itself. Charges against the cargo *after* it has left the custody of the carrier would be billed to and paid by cargo, not the carrier.

Manifest fee: Frode admits¹³ this to be a charge for services by Frode. It is clearly incident to the earning of freight. Frode's contention that Clause 14 of the bill of lading applies to this item is untenable. The clause comes into effect only with respect to expenses and penalties not contemplated by the parties.

Handling charges at San Francisco: These are admitted to have been stevedoring charges.¹⁴ Such charges are held in *The Jane Grey* to be a part of the "freight then pending". Frode has not contested the holding of *The Jane Grey*.

Wharfage at San Francisco:¹⁵ There is no evidence before this Court that this sum has been turned over *in toto*, or otherwise to anyone. Whether or not the accounting has been made, however, is immaterial. A portion of the freight money was undoubtedly turned over to members of the crew of the SS. Frej as wages, or spent to purchase fuel oil for the voyage. The mere fact that wharfage charges in San Francisco were not a "net profit" item to Frode does not make them deductible from the limitation fund.

¹³Appellee's Opening Brief, p. 29.

¹⁴Appellee's Opening Brief, p. 30.

¹⁵Appellee's Opening Brief, p. 30.

Frode mentions "*Pacific Coast v. Reynolds*, 114 F. 877", frequently.¹⁶ *Pacific Coast Co. v. Reynolds* definitely supports the position of Rice Growers and is cited in decisions cited by Rice Growers. The *Reynolds* case involved the amount of freight and passage fares to be included in a limitation fund. Freight and passage fares were both prepaid. However, the freight *was not earned, vessel lost or not lost*, under the bill of lading. For *this reason* the Court held that the freight, not being earned, was not pending and the Court did not include the gross freight in the limitation fund. The Court specifically refused to consider whether the items making up the gross freight were properly regarded as freight. On the other hand, where *passage money was specifically* (by the terms of the tickets) *earned, vessel lost or not lost*, the Court held that the complete passage money must be placed in the limitation fund, and that the expenses of ultimately earning the passage money were not deductible. In 1939 this Honorable Court, speaking through Judge Denman in *Hazel Brashear v. Union Dredging Co.*, 1939 A.M.C. 944, 104 Fed. (2d) 762, clearly recognized that "pending freight" was the "gross earnings of the dredge without deductions of any kind". The language, of a case where freight was *not* "earned, vessel lost or not lost" cannot be cited with respect to this litigation, for the simple reason that in this case the gross freight *was* "*earned, vessel lost or not lost*", and hence is pending.

¹⁶Appellee's Opening Brief, p. 27; quotation, p. 33.

Whether or not these items were turned over to parties actually doing the work, each item represents nothing more than expenditures by Frode incident to the earning of "gross freight". Frode performed these items in order to earn the gross freight. Such expenses, merely because itemized on the bill of lading, can no more be deducted from the gross freight surrendered into the limitation fund than (as in the language of *The Jane Grey*) the wages of the captain and crew, the cost of supplies for the vessel, commissions to ship's agents, or stevedoring charges.

CONCLUSION.

For the foregoing reasons, the order should be reversed and the limitation fund fixed at \$392,982.03, as stated in our opening brief.

Dated, San Francisco, California,
April 18, 1949.

Respectfully submitted,

GEORGE H. HAUERKEN,
HAUERKEN & ST. CLAIR,

Proctors for Appellant.



No. 12,074

IN THE

**United States Court of Appeals
For the Ninth Circuit**

RICE GROWERS ASSOCIATION OF CALI-
FORNIA (a corporation),

Appellant,

VS.

REDERIAKTIEBOLAGET FRODE (a corpo-
ration), Owner of the Steamship
"Frej",

Appellee.

**MEMORANDUM IN OPPOSITION TO
APPELLEE'S MEMORANDUM ON SCOPE OF REVIEW.**

GEORGE H. HAUERKEN,
HAUERKEN & ST. CLAIR,
535 Russ Building, San Francisco 4, California,
Proctors for Appellant.

FILED

MAY 23 1949

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**MEMORANDUM IN OPPOSITION TO
APPELLEE'S MEMORANDUM ON SCOPE OF REVIEW.**

Frode's Memorandum is entitled "Memorandum on Scope of Review" and purports to be filed in answer to a specific question raised by the Court at the oral argument (whether this Court has power to fix the limitation fund as of May 8, 1947, although Frode took no cross-appeal from the order of the District Court). In fact, however, the memorandum is not limited to that question but covers the entire case. We assume of course that that part of the memorandum which is thus unauthorized will not be read. Since it is possible, however, that the memorandum will be con-

sidered in its entirety, we hereby respectfully apply for leave to file the following answer thereto.

THE SCOPE OF THE REVIEW BY THIS COURT.

We have of course no quarrel with the contention of Frode that an appeal in admiralty results in a trial *de novo*. Our contention is, however, that the scope of that trial *de novo* is restricted to the issues raised by the specifications of error.

Frode cites two cases decided in 1887 and 1921 respectively by the Supreme Court of the United States. Those cases (*Irvine v. The Hesper*, 122 U.S. 256, 30 L. Ed. 1175, and *The John Twohy*, 255 U.S. 77, 65 L. Ed. 511) do seem to support Frode's contention. Frode does not cite, however, the later case of *Oxford Paper Co. v. The Nidarholm*, 282 U.S. 681, 75 L. Ed. 614, decided in 1931 by the Supreme Court of the United States, and which must be deemed to have overruled the two previous cases. In that case the charterer of the SS Nidarholm filed a libel in rem to recover damages for the loss of part of his cargo. The District Court held that the shipowner was alone at fault and awarded damages accordingly. On appeal by the shipowner, the Circuit Court of Appeals held that both the shipowner and the charterer were at fault and accordingly divided the damages. The Supreme Court then granted certiorari on petition of the charterer. The shipowner was apparently content with the decision that he was half to blame. The

Supreme Court concluded that the charterer alone was to blame, but nevertheless did not relieve the shipowner from his half of the damages, for the reason that the shipowner had not applied for certiorari.

Frode also relies on *Brooklyn Eastern District Terminal v. United States*, 287 U.S. 170, 77 L. Ed. 240, and *Callan v. Cope*, 165 F. (2d) 703. Neither of these cases is in point. They both recognize that an appeal in admiralty amounts to a trial *de novo*, but neither of them raises the question of whether the appellee can, without filing a cross-appeal, ask the appellate Court to review issues which are not covered by the appellant's specification of errors.

To hold, as Frode now suggests, that an issue can be raised at the oral argument on appeal, even though it was not assigned as error, does away with the requirements of Rule 35 of the Rules of this Honorable Court.

Frode also makes the preposterous contention that it would have been necessary for Rice Growers to expressly exclude the date of May 8, 1947, from its assignment of errors in order to preclude consideration of that date by this Court. In effect, Frode contends that it is necessary for an appellant to expressly state that it is not appealing from a ruling which is unfavorable to the other party. It is submitted that there is only one way to construe the assignments of errors filed by Rice Growers, whether the assignments be read as a whole or whether each of them be read separately. Rice Growers assigned as error

the ruling of the trial Court fixing June 19, 1947, the date of the termination of the voyage, and at \$213,104.00 the amount of the limitation fund. As far as Rice Growers was concerned, those rulings were erroneous only in not fixing the termination of the voyage at a later date and the limitation fund at a greater amount. Since, as against a date prior to June 19, 1947 and as against an amount smaller than \$213,104.00, the ruling of the trial Court was not erroneous, the assignments of errors filed by Rice Growers cannot possibly be construed as being broad enough to allow this Court to consider any date prior to June 19 and any amount smaller than \$213,104.00.

THE UNAUTHORIZED PART OF FRODE'S MEMORANDUM.

On page seven of its memorandum, Frode cites several recent cases, which, with the exception of *The Lara*, 1947 A.M.C. 27, had not heretofore been cited by the parties. Those cases have one thing in common and that is that none of them has anything whatever to do with the question of the termination of the voyage raised in our case.

The Mattie, 34 F. S. 856, deals with the question of whether a petition for limitation should be denied because the owner of the vessel replaced her steering gear before surrendering her to a trustee, *not* with the question of the termination of the voyage.

The Edward Luckenbach, 1942 A.M.C. 1449, deals with the question of what docket fees are to be al-

lowed proctors for the cargo claimants in a limitation proceeding, *not* with the question of the termination of the voyage.

The Chickie, 54 F. S. 19, deals with the question of the privity and knowledge of the owner and the question of whether he can avail himself of the limitation statute, although he failed to either deposit security or surrender the vessel to a trustee, *not* with the question of the termination of the voyage.

Curtis Bay Towing Co. v. Tug Kevin Moran, 159 F. (2d) 273, deals with the question of whether an order refusing to dissolve an injunction is appealable and whether, assuming it to be appealable, the injunction should be dissolved, *not* with the question of the termination of the voyage.

We do not know why Frode cited those cases. It is true that each of them cites one or more older cases, such as *The City of Norwich*, 118 U.S. 468, 30 L. Ed. 134, which Frode has previously cited to this Court. It is claimed by Frode that those older cases held that "a catastrophe terminates the voyage". The fact is, however, that they do not so hold. Nor do the recent cases, which have themselves nothing whatever to do with the question of the termination of the voyage, cite the older ones for the proposition that "a catastrophe terminates the voyage". As was pointed out in our previous briefs, those older cases rather stand for the proposition that a voyage can be terminated short of destination only in the event that (1) the vessel is a total loss, or (2) the vessel is so damaged as to make

it unreasonable for her owner to repair her, or (3) the voyage was in fact commercially frustrated.

It is submitted that the 1936 amendment to the Limitation Statute was merely procedural and was only intended to "require the shipowner to act promptly in asserting the right to limit his liability." (*Petition of Goulandris*, 140 F. (2d) 780, 781.) Although no case has actually passed upon the question of whether, since the 1936 amendment, limitation can be had before the end of the voyage, the Supreme Court has made it clear, by the recent amendment to Rule 51 of its Admiralty Rules, that the limitation fund must now, as it had to before 1936, be fixed as of the end of the voyage. Rule 51 now requires the petition for limitation of liability to set forth:

"the value of the vessel at the close of the voyage or, in case of wreck, the value of her wreckage, strippings or proceeds, if any * * *"

Rule 51 further provides that the *ad interim* stipulation shall be for:

"the value of petitioner's interest in the vessel at the close of the voyage or, in the case of wreck, the value of the wreckage, strippings or proceeds, * * *"

It is therefore clear that Rule 51 supports the position which has been that of *Rice Growers* throughout this case, namely, that limitation can be had only as of the time when the vessel actually arrived at destination, or as of the time when a wreck in fact terminated her voyage.

Frode still argues that the "Frej" was "a helpless wreck, aground, requiring repairs in excess of 150% of its value". The fact is, however, that she was not a helpless wreck, that she was beached for convenience and that she was repaired for less than 61% of her repaired value. \$167,498.99 were expended for repairs and her value, when she resumed the voyage, was \$275,000. Although it is true that the cost of repairing the "Frej" exceeded her value as of May 8, 1947, the significant fact is that the cost of repairing her did not exceed her value when repaired. Frode expended \$167,498.99 (instead of abandoning \$106,000) and thereafter had a ship worth \$275,000.

To say that a vessel which was repaired and completed her voyage was a "helpless wreck" (as stated by Frode) or "wreckage and strippings" (as contemplated by Supreme Court Admiralty Rule 51) is to do violence to the truth.

In any event, and even if, as suggested by Judge Denman at the oral argument, the 1936 amendment to the limitation statute be held to give the shipowner the right to terminate a voyage at any time he pleases in order to secure limitation as of that time, it is clear that that right can become effective only from the time when the shipowner claims the benefit of the limitation statute.

If the Frej was in fact a total loss on May 8 or if her voyage was commercially frustrated on that day, Frode was entitled to invoke the benefit of the limitation statute as of that date, irrespective of the effect of the 1936 amendment, for her voyage was ended on

that date. If, however, she was not a total loss on May 8 and her voyage was not then commercially frustrated, it was necessary for Frode to await the end of her voyage, or, if the theory suggested by Judge Denman be adopted, it was necessary for Frode to terminate that voyage by the filing of a petition for limitation of liability and the posting of the necessary security. (*Petition of Goulandris*, 140 F. (2d) 780.) The abortive notice of abandonment of June 19 was not enough; it was nothing but an attempt by Frode to escape its contractual obligations. If the statute now gives the right to terminate the voyage as soon as claims in excess of the value of the vessel have been filed with her owner, it must be required of the owner, before the voyage can be said to have been terminated, that he comply with the statute by filing a petition for limitation of liability and by posting the necessary security or surrendering his vessel to a trustee. *In our case, those requirements were not fully complied with by Frode until August 4, 1947, and that date is accordingly the earliest date as of which Frode can possibly be entitled to limit its liability.*

We have no quarrel with the proposition that the limitation statute must be liberally construed in order to encourage investment in shipbuilding and with the cases cited by Frode in support of that proposition. It should be emphasized, however, that neither *Coryell v. Phipps*, 317 U.S. 406, 87 L. Ed. 363, nor *Just v. Chambers*, 312 U.S. 383, 85 L. Ed. 903, have anything whatever to do with the question of valuation. The latter case deals with the question of the enforceability

in Admiralty of claims for personal injuries against the estate of a deceased shipowner. In the former case, the Court was concerned with the question of privity and knowledge of the shipowner. The only case which we have found dealing with the question of whether the statute should be given a strict or liberal construction on the issue of valuation is the case of *La Bourgogne*, 210 U.S. 95, 52 L. Ed. 973. In that case, in referring more particularly to the freight portion of the limitation fund, the Court stated at page 992 of 52 L. Ed.:

“the duty to surrender pending freight to entitle to a limitation of liability must be liberally construed *against* the shipowner.” (Italics supplied.)

Moreover, there is no construction of the statute involved in this case, unless of course the suggestion made by Judge Denman be adopted. The statute otherwise needs no construction for the simple reason that it has been repeatedly construed and that it is settled that valuation must be made as of the end of the voyage.

In conclusion, to use the language of the English Court of Appeal:

“It is absurd to argue that the shipowner can say that he was prevented from fulfilling his contract by perils of the sea by reason of great expense of repairing, when he did in fact repair and proceed upon a voyage.” (*Assicurazioni Generali v. S.S. Bessie Morris Co.* (VII Aspinall’s Reports (N.S.) 217.)

The “Frej” *did* complete her voyage (Havana); the “close of the voyage” (Supreme Court Admiralty Rule 51) *was* Havana. The limitation fund must accordingly be taken as of the time and place set by all the cases and the Supreme Court in its Admiralty rules. That time and place was September 18, 1947, in Havana.

Dated, San Francisco,
May 27, 1949.

Respectfully submitted,

GEORGE H. HAUERKEN,
HAUERKEN & ST. CLAIR,

Proctors for Appellant.

No. 12,074

IN THE

**United States Court of Appeals
For the Ninth Circuit**

RICE GROWERS ASSOCIATION OF CALIFORNIA
(a corporation),

Appellant,

vs.

REDERIAKTIEBOLAGET FRODE (a corporation),
Owner of the Steamship "Frej",

Appellee.

APPELLANT'S PETITION FOR A REHEARING.

GEORGE H. HAUERKEN,

HAUERKEN & ST. CLAIR,

535 Russ Building, San Francisco 4, California,

*Proctors for Appellant
and Petitioner.*

FILED

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IN THE
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RICE GROWERS ASSOCIATION OF CALIFORNIA
(a corporation),

Appellant,

VS.

REDERIAKTIEBOLAGET FRODE (a corporation),
Owner of the Steamship "Frej",

Appellee.

APPELLANT'S PETITION FOR A REHEARING.

*To the Honorable William Denman, Presiding Judge,
and to the Honorable Associate Judges of the
United States Court of Appeals for the Ninth
Circuit:*

Appellant Rice Growers Association of California, hereinafter referred to as Rice Growers, respectfully petitions for a rehearing of the above entitled cause, following the decision of this Honorable Court rendered on June 24, 1949. The rehearing is sought only as to the question of the value of the S.S. "Frej" for limitation purposes and not as to the question of freight.

The opinion can be summarized as follows:

(1) The limitation of liability statute must be liberally construed in favor of the shipowner.

(2) When so construed, the statute gives the shipowner the right to terminate his voyage at any time after claims exceed the value of his vessel.

(3) Although the right to terminate his voyage is given him by the statute, the shipowner need not, when so terminating it, comply with any of the requirements of the statute.

In support of the first proposition, the opinion cites *Just v. Chambers*, 312 U.S. 383, 85 L.Ed. 903, and *Coryell v. Phipps*, 317 U.S. 406, 87 L.Ed. 363. In support of the second and third propositions, the opinion cites nothing.

To construe the limitation statute liberally in favor of the shipowner does not mean that every issue arising between him and cargo must be decided in his favor. It must first be determined whether the issue calls for a construction of the statute. The issue raised in this case (the termination of the voyage) does not call for any construction of the statute, for the simple reason that the statute does not purport to come into effect until it has *otherwise* been determined that the voyage is at an end. It has repeatedly been held that the rights which the statute gives to the shipowner arise only at the termination of his voyage. The statute assumes that, under the general maritime law, the voyage was at an end; it does not concern itself with how it ended, whether by arrival at destination or by destruction of the vessel short of destination.

Nor does it purport to give to the shipowner a right to terminate his voyage which is denied him by the general maritime law. (See, *The Maggie Hammond v. Morland*, 9 Wall. 435, 19 L.Ed. 772; *Assicurazioni Generali v. SS. Bessie Morris Co.*, VII Aspinall's Reports (N.S.) 217.)

In both *Just v. Chambers*, supra, and *Coryell v. Phipps*, supra, the issues as to which the Supreme Court of the United States stated that the statute should be liberally construed arose in the course of the limitation proceeding, *after* the shipowner had complied with all the requirements which open the door to the proceeding. There was apparently no question as to when and where the voyage terminated in those cases. Moreover, both *Chambers* and *Phipps* had apparently posted the security necessary to enable them to insist upon a liberal construction of the limitation statute. The issue in this case, however, arises before the gate of the statute is opened and there is no authority anywhere for the proposition that an issue of that kind should be liberally determined in favor of the shipowner. On the contrary, the Supreme Court of the United States has held that the preliminary issue of compliance with the requirements of the statute must be strictly determined against the shipowner. In *The Main v. Williams*, 152 U.S. 122, 38 L. Ed. 381, in determining what the shipowner had to surrender as freight, the Court stated at page 385 of 38 L. Ed.:

“The English courts have held, very properly we think, that these statutes should be strictly con-

strued. As observed by Abbott, *Ch. J.*, in *Gale v. Laurie*, 5 Barn. & C. 156, 164: 'Their effect, however, is to take away or abridge the right of recovering damages, enjoyed by the subjects of this country at the common law, and there is nothing to require a construction more favorable to the ship owner than the plain meaning of the word imports.' To the same effect are the remarks of Sir Robert Phillimore in *The Andalusian*, 3 Prob. Div. 182, 190, and in *The Northumbria*, L. R. 3 Adm. 6, 13. Speaking of this statute, Lord Justice Brett in *Chapman v. Royal Netherlands Steam Nav. Co.*, L. R. 4 Prob. Div. 157, 184, remarked: 'A statute for the purposes of public policy, derogating to the extent of injustice, from the legal rights of individual parties, should be so construed as to do the least possible injustice. This statute, whenever applied, must derogate from the direct right of the ship owner against the other ship owner. * * * It should be so construed as to derogate as little as is possible consistently with its phraseology, from the otherwise legal rights of the parties.'

"While, from the universal habit of insuring vessels, the application of the statute probably results but rarely in an actual injustice to the owner of the injured vessel, yet, being in derogation of the common law, we think the court should not limit the right of the injured party to a recovery beyond what is necessary to effectuate the purposes of Congress." (Italics added.)

No case has ever held before, as this Honorable Court now holds, that the statute gives the shipowner a right to terminate the voyage which he otherwise

would not have. The opinion restates the established rule that valuation must be had as of the end of the voyage, and then proceeds to destroy that rule with the announcement that the voyage may of course be terminated and valuation accordingly be had at any time the shipowner pleases. It is submitted that the test announced by all the cases and by Rule 51 of the Admiralty Rules of the Supreme Court (which, incidentally, was revised by the Supreme Court *after* its decision in *Just v. Chambers*, supra, and *after* its decision in *Coryell v. Phipps*, supra), is an objective and not a subjective test.

Rule 51 now requires the petition for limitation of liability to set forth:

“The voyage on which the demands sought to be limited arose, with the date and place of its termination; * * *

The value of the vessel at the close of the voyage or, in case of wreck, the value of her wreckage, strippings or proceeds, if any, * * *”

Rule 51 further provides that the *ad interim* stipulation shall be for:

“The value of petitioner’s interest in the vessel at the close of the voyage or, in the case of wreck, the value of the wreckage, strippings or proceeds, * * *”.

It is, therefore, clear that Rule 51 supports the position which has been that of Rice Growers throughout this case, namely, that limitation can be had only as of the time when the vessel actually arrived at

destination, or as of the time when a wreck in fact terminated her voyage. The Supreme Court would not, throughout Rule 51, insist upon "the voyage", if all it meant was that the shipowner may pick out the date as of which valuation must be had.

If the shipowner can, for limitation of liability purposes, terminate his voyage at any time he pleases, there is no reason to require him to surrender the value of his interest in the vessel "at the close of the voyage"; all that is necessary is to allow him to surrender it "at any time he pleases". Moreover, if he can thus shorten the voyage, for limitation of liability purposes, there is no reason why he should not be allowed to expand it for the same purpose so as to include in one limitation proceeding all the claims which arose during any given six months' period.

Both in its briefs and at the oral argument Rice Growers took the position that, since a limitation of liability proceeding is equitable in nature, Frode should be required to do equity before coming into Court and asking for a liberal construction of the statute. Rice Growers accordingly contended that this case could not be decided without a determination of whether or not the abandonment of the voyage on June 19 was wrongful. Frode gave no answer to that contention either in its briefs or at the oral argument and now this Court gives no answer thereto. It is true that the contention is noted in the opinion and that it is therein seemingly conceded that equitable principles control. How they control, however, is unfortunately not made clear. Nor is it made clear how

they can control in a decision in which the question of whether the party seeking equity must first do equity is expressly left open.

This Court now holds (for the first time) that a shipowner may terminate a voyage whenever claims against him exceed the value of the vessel, irrespective of whether the vessel arrived at destination or was wrecked. This Court further holds (for the first time) that that right is given him by the limitation statute. If that right does stem from the statute, however, the time when the statute is invoked is the only possible time (always bearing in mind that there was neither wreck nor actual completion of the voyage) when the voyage can be terminated.

Section 185 of 46 U. S. Code provides as follows:

“The vessel owner, * * * may petition a district court of the United States * * * for limitation of liability * * * and the owner (a) shall deposit with the court, for the benefit of claimants, a sum equal to the amount or value of the interest of such owner in the vessel and freight, or approved security therefor, and in addition such sums, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title, or (b) at his option shall transfer, for the benefit of claimants, to a trustee to be appointed by the court his interest in the vessel and freight, together with such sums, or approved security therefor, as the court may from time to time fix as necessary to carry out the provisions of section 183 of this title. *Upon compliance with the requirements of this section all claims and proceedings against the*

owner with respect to the matter in question shall cease." (Italics added.)

Rule 51 of the Admiralty Rules of the Supreme Court provides in part as follows:

"The owner or owners of any vessel who shall desire to claim the benefit of limitation of liability provided for in the third and fourth sections of the Act of March 3, 1851, entitled 'An Act to limit the liability of shipowners and for other purposes' (Sections 183 to 189 of Title 46 of the U. S. Code, 46 U.S.C.A. §§ 183-189) as now or hereafter amended or supplemented, *may file a petition in the proper District Court of the United States, as hereinafter specified.*" (Italics added.)

If Section 185 and the quoted part of Rule 51 mean anything, they mean that, in order to be entitled to the benefits of the limitation statute, the shipowner *must first* file his petition and otherwise comply with the requirements of the statute.

It has repeatedly been held that the statute must be strictly complied with, even though it be liberally construed, before the shipowner can claim the benefits provided thereunder. In *The Chickie* (C.C.A. 3, 1944) 141 Fed. (2d) 80, for example, the Court referred at p. 85 to "the well settled rule that the Courts are to construe the statute liberally" and nevertheless held that

"the proceeding on the petition was never sufficiently completed for the jurisdiction of the court to attach to this extent. All that the owners did was to file their petition. There was no trans-

fer of a res to a trustee; no monition ever issued; the required fee for filing the petition was not even paid. The petition had no legally operative effect; we may dismiss it from further consideration." (141 F. (2d) at 84.)

Similarly, in *Petition of Goulandris* (C.C.A. 2, 1944), 140 F. (2d) 780, certiorari denied 322 U.S. 755, 88 L. Ed. 1584, the Court dismissed a petition for limitation of liability filed within the 6 months' period and accompanied by a stipulation for costs on the ground that the petitioning shipowner had failed to comply with the requirement of the statute by either surrendering his vessel or posting adequate security.

In *In re Jacobson*, 52 F. (2d) 179, the Court stated at p. 180:

"Limiting as it does the common-law doctrine of responsibility for the acts of servants and agents, *this statute makes a very valuable concession, neither to be frittered away by undue restrictions upon it nor to be incontinently allowed except upon full compliance with the conditions of the grant.* Cases like *The Annie Faxon* (C.C.A.), 75 F. 312; *People's Navigation Co. v. Toxey* (C.C.A.), 269 F. 793; *Kitsap County v. Harvey* (C.C.A.), 15 F. (2d) 166, 48 A.L.R. 1420, in their emphasis upon the difference between the personal and the imputed fault of the owner have tended to over-emphasize the exemption from liability; other cases stressing the necessity for compliance with the conditions fixed as the basis for the enjoyment of the exemption have clarified, or at least brought into balance, some of the expressions in

those cases. Cases of this kind are *Great Lakes Towing Co. v. Mill Transportation Co.* (C.C.A.), 155 F. 11, 20, 22 L.R.A. (N.S.) 769; *Benner Line v. Pendleton* (C.C.A.), 217 F. 497, 500; *The Etna Maru* (D.C.), 20 F. (2d) 143; *Christopher v. Grueby* (C.C.A.), 40 F. (2d) 8." (Italics added.)

In *Standard Wholesale P. & A. Works v. Travelers Ins. Co.* (C.C.A. 4, 1939), 107 Fed. (2d) 373, the Court stated at p. 376:

"The right of the owner of a vessel to limit liability is wholly statutory in the United States. *The Main v. Williams*, 152 U.S. 122, 14 S.Ct. 486, 38 L.Ed. 381, and authorities there cited. *To avail himself of this right granted by the statute the owner must bring himself within the terms fixed by the statute. While the purpose of the statute is to protect and encourage maritime commerce and, while statutes of this character are to be liberally construed, this liberality of construction cannot be extended so that express conditions laid down by the statute itself are waived or ignored.*" (Italics added.)

It should finally be noted that Congress itself has recently indicated that the new liberal attitude adopted by the Supreme Court in those cases in which the shipowner has fully complied with the statute shall not be applied in those cases in which the preliminary issue is raised of whether the shipowner did fully comply with the statute. In 1936, Congress amended Section 185 to require the shipowner to file his petition for limitation of liability within six (6) months after the filing of claims. It has repeatedly

been held that that amendment was intended *to cut down and not to enlarge the rights of the shipowner*. (See *Petition of Goulandris*, supra; *Standard Wholesale P. & A. Works v. Travelers Ins. Co.*, supra.)

It is therefore clear that, if the shipowner can claim no rights under the statute, even though he filed his petition, unless he also complies with all the other requirements of the statute, he cannot claim any rights thereunder at the time when he has not even filed his petition and when, for all that appears, he does not even contemplate filing a petition. *When on June 19, Frode purported to terminate the voyage, it not only had not filed any petition for limitation of liability, but it had not even indicated in any way that it intended ever to do so*. Under the circumstances, it cannot possibly be held that the right to unilaterally terminate the voyage, which, under the opinion of this Honorable Court is a new right given to the shipowner by the statute, can be invoked before the statute itself has been invoked.

The situation is analogous to that presented under the Bankruptcy Act. Let us assume that, on June 19, Frode was in effect insolvent and would have been entitled to claim the benefit of the Bankruptcy Act as of that date, upon surrender of its assets (the "Frej") to a trustee in bankruptcy. Let us further assume that instead of *filing a petition* in bankruptcy on June 19, Frode elected to wait until July 26 and to file it on that date. It is of course clear that Frode would have to surrender its assets (the "Frej") in the condition in which they were on July 26 and not in the

condition in which they were on June 19. Failure to surrender its assets as of July 26, would result in a denial by the Court of the rights to which Frode would otherwise be entitled under the Bankruptcy Act.

It is submitted that the situation is exactly the same under the limitation of liability statute and that, *just as there is only one way to claim the benefits of the Bankruptcy Act, there is only one way to claim the benefits of the limitation of liability statute: by filing a petition, surrendering the vessel or posting security and otherwise fully complying with the requirements of the statute.* Until that has been done, none of the rights which are given the shipowner by the statute can possibly accrue.

For the foregoing reasons, a rehearing should be granted.

Dated, San Francisco, California,
July 20, 1949.

Respectfully submitted,

GEORGE H. HAUERKEN,

HAUERKEN & ST. CLAIR,

*Proctors for Appellant
and Petitioner.*

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for appellant and petitioner in the above entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact and that said petition for a rehearing is not interposed for delay.

Dated, San Francisco, California,
July 20, 1949.

GEORGE H. HAUERKEN,
*Of Counsel for Appellant
and Petitioner.*



No. 12,074

IN THE

United States Court of Appeals
For the Ninth Circuit

RICE GROWERS ASSOCIATION OF CALIFORNIA
(a corporation),

Appellant,

VS.

REDERIAKTIEBOLAGET FRODE (a corporation), Owner of the Steamship "Frej",

Appellee.

APPELLEE'S PETITION FOR A REHEARING.

CLARENCE G. MORSE,

GRAHAM & MORSE,

310 Sansome Street, San Francisco,

Proctors for Appellee.

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JUL 25 1949

PAUL P. O'BRIEN,

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No. 12,074

IN THE
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REDERIAKTIEBOLAGET FRODE (a corporation),
Owner of the Steamship "Frej",
Appellee.

APPELLEE'S PETITION FOR A REHEARING.

*To the Honorable William Denman, Presiding Judge,
and to the Honorable Associate Judges of the
United States Court of Appeals for the Ninth
Circuit:*

Rederiaktiebolaget Frode (a corporation) owner of the Steamship "Frej" and appellee in the above entitled cause, hereby respectfully submits this its petition for a rehearing respecting this Honorable Court's determination on the following two points:

Point I. That the date for valuation of the limitation of liability fund was June 19, 1947, rather than May 8, 1947; and

Point II. That payments by cargo aggregating \$8,873.03 for landing fees, manifest fees, handling and wharfage charges should be included in the limitation of liability fund in additon to ocean freight.

POINT I.

Appellee requests rehearing as to the date of valuation solely because of its belief that this Court may have inferred that the appellee considers the voyage of the "Frej" to have continued until June 19, 1947, (a) by reason of certain references in appellee's brief on appeal to "termination of the voyage on June 19, 1947;" and (b) by reason of the vessel's retention of the cargo subsequent to May 8, 1947.

(a)

Appellee's position consistently throughout the proceeding both in the District Court and in this Court has been that the voyage of the "Frej" was automatically terminated by the catastrophe on May 8, 1947, but that in any event the voyage was concluded by appellee's formal abandonment of the voyage on June 19, 1947.

Appellee's position is fairly stated on page 25 of its brief on appeal:

"Appellee Frode believes, and asserted in the District Court, that the voyage of the 'Frej' was automatically terminated by reason of the damages and stranding resulting from the fire within

the rule recognized by this Honorable Court in *Boston Marine Insurance Co. v. Metropolitan Redwood Lumber Co.*, 197 F. 703 at 712, in which the voyage was deemed terminated at sea by the collision, even though the vessel remained afloat and was towed into port.

“Since the voyage was automatically terminated on May 8, 1947, by the disaster, *a fortiori* the voyage was ended when formally abandoned by Frode on June 19, 1947.”

Appellee's brief dealt at greatest length with the question of formal abandonment. It was only appellee's fear of unnecessarily cumbersome draftsmanship that caused it to refrain from restating its belief that the voyage was terminated on May 8, 1947, by the catastrophe with each of its references to the definitively terminating effect of the formal abandonment of June 19, 1947.

Appellee has been consistent in its position, for example, in the petition for limitation of liability it was clearly stated that the voyage terminated on May 8, 1947, and that the limitation of liability fund should be determined as of that date (Apostles on Appeal pp. 5, 8). The *ad interim* stipulation for value pending appraisal likewise recites that the voyage terminated on May 8, 1947 (Apostles on Appeal p. 16). The amended order for monition fixing time and place for filing claims and restraining actions contains a similar recital (Apostles on Appeal p. 25). In petitioner's opening brief on valuation in the trial Court Frode urged the trial Court to fix the limitation

fund as of May 8, 1947. In that respect in the "Conclusion" of the brief it is stated in part:

"We conclude that:

"(1) The voyage was automatically terminated on the occurrence of the fire, which commenced on May 6, 1947, because the circumstances were of sufficient gravity to break up the voyage;

"(2) Even if incorrect in our first conclusion (with which we are satisfied), alternatively a ship owner has the *power* at any time or place to terminate a voyage, irrespective of the degree of damage to the vessel, and then and there fix the limitation fund, which *power* petitioner exercised by officially and formally abandoning the voyage at San Francisco, California, on June 19, 1947, and this is the latest date and place where and when the vessel is to be valued for the limitation fund."

It is respectfully submitted that appellee has at no time conceded that the voyage of the "Frej" continued beyond May 8, 1947. This Court's ruling that appellee was entitled to terminate the voyage on June 19, 1947, is fully supported by the principles established in previous decisions and generally recognized practice in limitation of liability proceedings, but in no way conflicts with appellee's position that the voyage of the "Frej" was in fact terminated by the catastrophe on May 8, 1947.

(b)

The retention of the cargo by the "Frej" after May 8, 1947, is no indication that the voyage continued.

The vessel had incurred heavy expenses of a general average nature and was entitled to retain possession of the cargo to protect its lien for the cargo's contribution to such expenses, particularly since at no time prior to June 19, 1947, did the appellant request repossession of the cargo at San Francisco.

In this connection it should be noted that it has long been the rule in this Court and in the United States Supreme Court that for limitation of liability purposes the value of the vessel must be taken as of the time that it suffers a catastrophe such as to terminate its voyage.

"The subsequent history of the wreck can only furnish evidence of its value at the point where the disaster terminated the voyage."

The City of Norwich, 118 U.S. 468 at 492;

Pacific Coast Co. v. Reynolds, 114 Fed. 877 at 881 (CCA 9, 1902).

In the opinion it is stated in part that Frode " * * * elected to abandon the voyage for carrying Growers' rice stating that it did so pursuant to bill of lading provisions * * *" and also "We do not agree that, having the right then to refuse to continue the voyage, the voyage was then any the less terminated because another reason, rightfully or wrongly, was given for such action—a question we do not decide". To be entirely accurate we respectfully call to this Honorable Court's attention the wording of the notice of abandonment issued by Frode on June 19, 1947, which recited in part (Apostles on Appeal, p. 51):

*“Frej on account various matters including but not being limited to extraordinary delays and expenses arising as a result of May 6, 1947 fire and acting under authority of applicable bills of lading and otherwise owner and master have elected to abandon voyage * * *”*

The wording of the notice clearly indicated Frode was not limiting itself to the exercise of privileges granted by the bill of lading but on the contrary Frode was asserting all rights it had under statute law as well as common law of the sea.

POINT II.

Appellee requests a rehearing as to this Court's determination that certain charges totaling \$8,873.03 other than ocean freight should be included in freight for limitation of liability purposes solely because of its belief that this Honorable Court inferred that such charges were treated as freight by the parties (a) by reason of the appearance of the portion of the bill of lading as set forth on page 7 of this Court's opinion, or (b) by reason of the assumption by this Court that the drafting and arrangement of the writing on the face of the bill of lading was prepared by the appellee, or (c) by reason of appellee's failure to prove conclusively that such charges are not charges for services by appellee to the cargo.

The portion of the bill of lading as shown on page 6 of this Court's opinion is an accurate copy of the

illustration appearing on page 12 of appellant's reply brief, but is not an accurate copy of any of the bills of lading in question, and therefore gives an erroneous impression. The word "FREIGHT" appearing on line 1 of page 6 does not appear in this manner on any of the bills of lading. As it actually appears on the bills of lading, it is apparent that it is intended to refer only to the first item, i.e., that of ocean freight. Likewise an additional line is omitted from the illustration, which omission radically changes the impression conveyed by the phrase "FREIGHT TO BE PREPAID/TO COLLECT". An inspection of the form of bill of lading contained in the original record will reveal that the phrase "FREIGHT TO BE PREPAID/TO COLLECT" is not intended to be descriptive of the total of the charges. A correct facsimile of the pertinent portions of the bills of lading in question is set forth herein as Appendix "A".

Any inference determinable from the arrangement or tabulation of the charges appearing on the face of the bill of lading should be construed against appellant and not against appellee since, although the forms were furnished by the vessel's agent, the forms were filled in and arranged by the appellant's freight forwarder as agent for appellant.

The failure of appellee conclusively to convince this Court that the extra charges were not for services by the vessel to the cargo does not and should not result in the inclusion of such items in the limitation fund where such items do not represent either freight or

earnings of the vessel *for the voyage*. Appellee's major contention in this regard is that the services for which the changes were made were not services to be performed during or *for the voyage*.

Dated, San Francisco,
July 25, 1949.

Respectfully submitted,
CLARENCE G. MORSE,
GRAHAM & MORSE,
Proctors for Appellee.

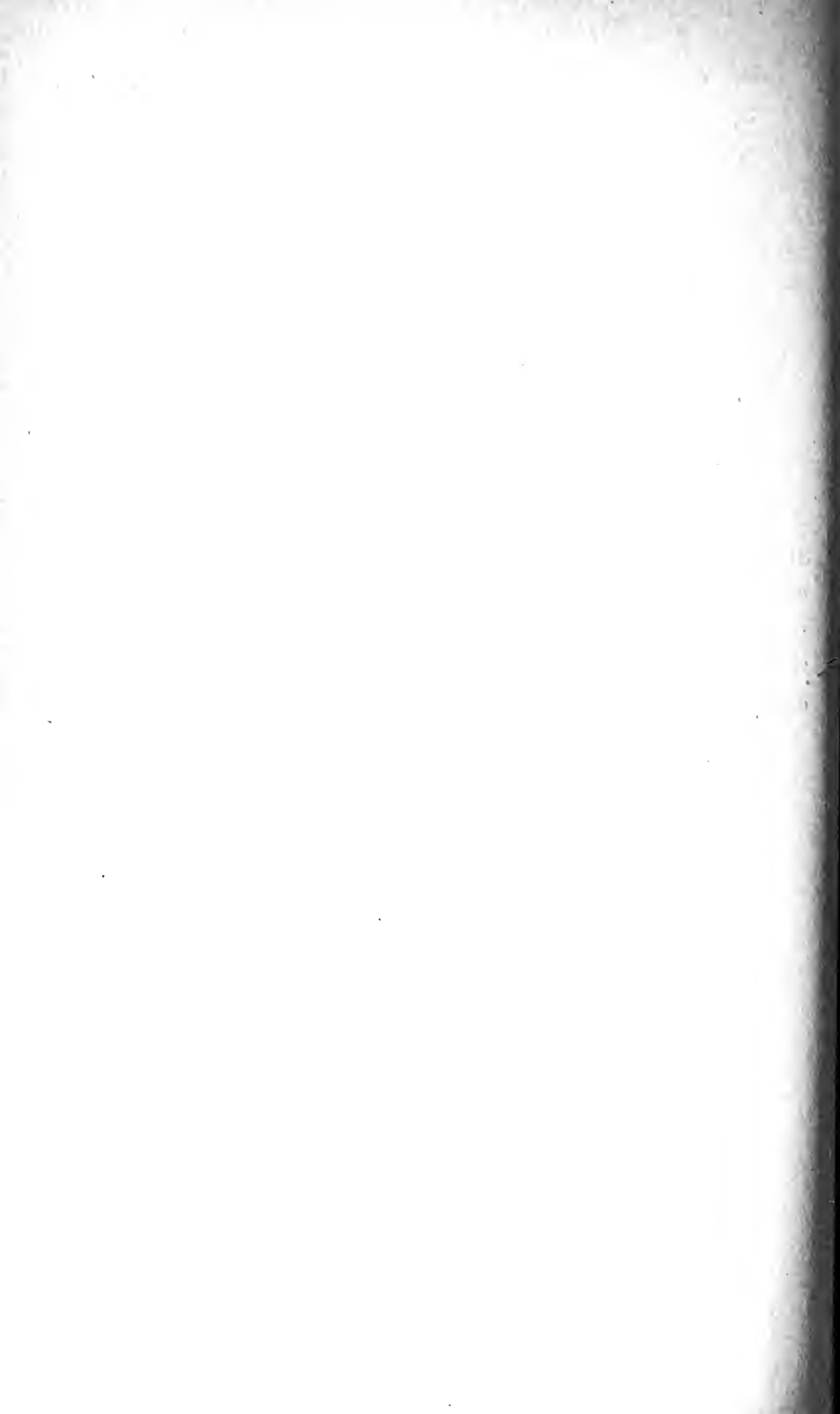
CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for appellee and petitioner in the above entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact and that said petition for a rehearing is not interposed for delay.

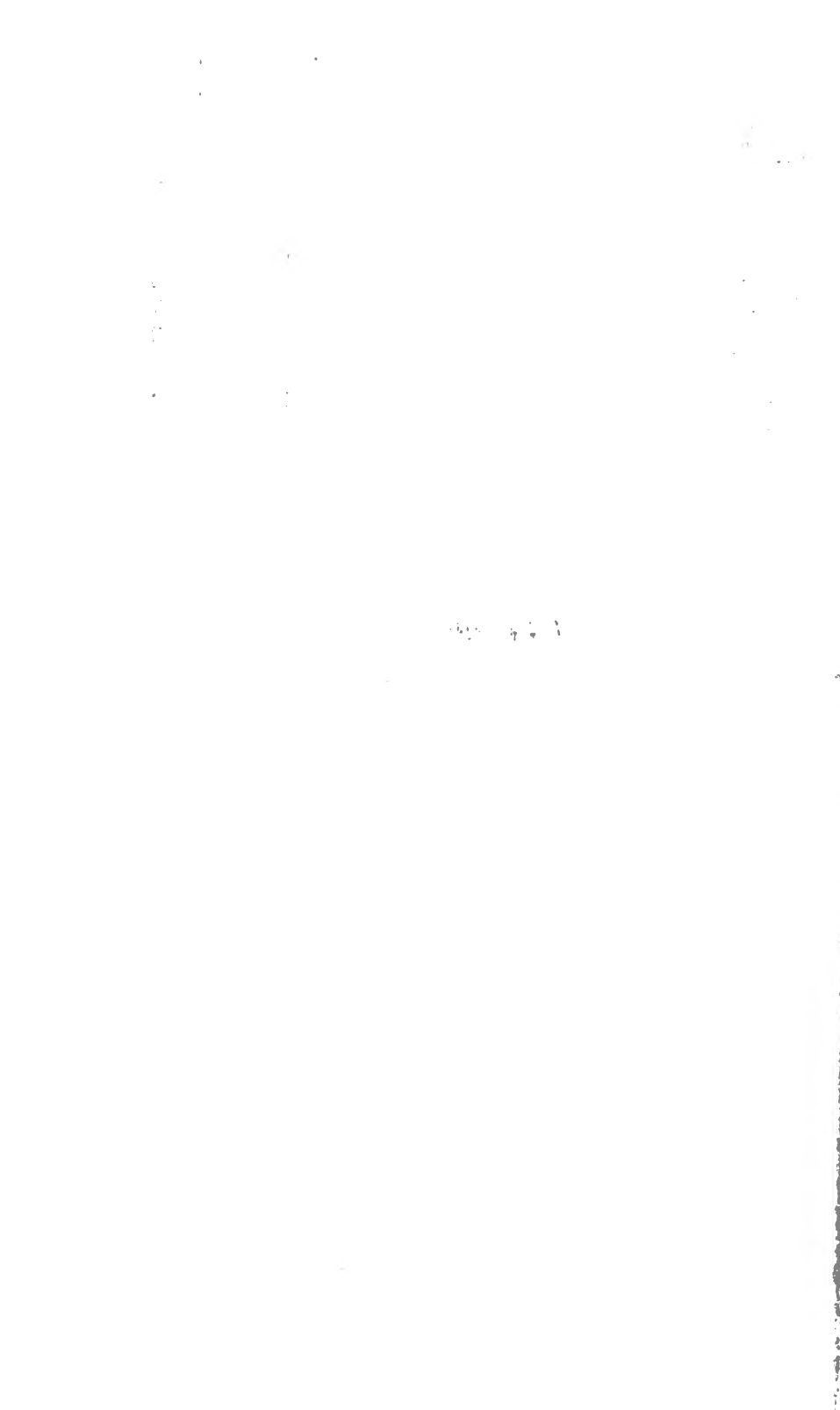
Dated, San Francisco,
July 25, 1949.

CLARENCE G. MORSE,
*Of Counsel for Appellee
and Petitioner.*

(Appendix "A" Follows)



Appendix.



These documents constitute known documents, the originals of which are in the possession of the United States within the meaning of the Espionage Act, 50 U.S.C. 32, and are hereby declared to be known documents within the meaning of the Espionage Act, 50 U.S.C. 32.

THE UNITED STATES OF AMERICA, by its Attorney General, hereby certifies that the foregoing documents are, with respect to the carriage of such goods if the vessel were to be chartered to carry such goods, a matter of national defense within the meaning of the Espionage Act, 50 U.S.C. 32, and that the disclosure of the contents of any document so described to an enemy of the United States would be injurious to the national defense.

This clause is to be construed only as an agreement that such cargo is a matter of national defense within the meaning of the Espionage Act, 50 U.S.C. 32, and that the disclosure of the contents of any document so described to an enemy of the United States would be injurious to the national defense.

IN WITNESS WHEREOF, I have hereunto set my hand and the seal of the United States at Washington, D.C., this 1st day of May, 1964.

JOHN F. KENNEDY, President of the United States of America.

*** (Cross out words not applicable)**



No. 12,076

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RAY BERG,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

JAMES M. CARTER,

United States Attorney,

ERNEST A. TOLIN,

Chief Asst. U. S. Attorney,

NORMAN W. NEUKOM,

Asst. U. S. Attorney,

Chief of Criminal Division,

LEILA F. BULGRIN,

Asst. U. S. Attorney,

United States Postoffice and
Courthouse Bldg., Los Angeles (12),

Attorneys for Appellee.



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No. 12,076

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RAY BERG,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

I.

Judicial Statement.

The offense in this case was charged in the information pursuant to the provisions of Title 49, Section 20(7)(b), of the United States Code. The District Court had jurisdiction of the cause under said Title 49, Section 20(7)(b) and Title 28, Section 28 of the United States Code, in effect at that time, which conferred on the District Courts original jurisdiction "of all crimes and offenses cognizable under the authority of the United States."

The offenses charged were committed in the City of San Diego, State of California. On April 28, 1947, the appellant appeared before the District Court for the Southern Division of the Southern District of California, for arraignment and plea. Judgment was entered on May 1, 1947.

Thereafter, under date of April 23, 1948, the appellant *in propria persona* filed a motion to correct the judgment and sentence. By order of the District Court, pur-

suant to a Waiver of Venue and Petition by appellant, the matter was transferred from the Southern Division to the Central Division of the Southern District of California. On October 14, 1948, an order was entered by the District Court denying the said motion. Notice of appeal was filed on October 6, 1948, and an Amended Notice of Appeal was filed on October 21, 1948.

This Court has jurisdiction under the provisions of Title 28, Section 1291 of the United States Code.

II.

Statute Involved.

Section 20(7)(b) of Title 49 provides:

“Any person who shall knowingly and willfully make, cause to be made, or participate in the making of, any false entry in any annual or other report required under this section to be filed, or in the accounts of any book of accounts or in any records or memoranda kept by a carrier, or required under this section to be kept by a lessor or other person, or who shall knowingly and willfully destroy, mutilate, alter, or by any other means or device falsify the record of any such accounts, records, or memoranda, or who shall knowingly and willfully neglect or fail to make full, true, and correct entries in such accounts, records, or memoranda of all facts and transactions appertaining to the business of the carrier, lessor, or person, or shall knowingly and willfully keep any accounts, records, or memoranda contrary to the rules, regulations, or orders of the Commission with respect thereto, or shall knowingly or willfully file with the Commission any false report or other document, shall be deemed guilty of a misdemeanor and shall be subject, upon conviction in

any court of the United States of competent jurisdiction to a fine of not more than five thousand dollars or imprisonment for not more than two years, or both such fine and imprisonment: *Provided*, That the Commission may in its discretion issue orders specifying such operating, accounting, or financial papers, records, books, blanks, tickets, stubs, correspondence, or documents or such carriers, lessors, or other persons as may, after a reasonable time, be destroyed, and prescribing the length of time the same shall be preserved."

III.

Questions Involved in the Appeal.

Appellant is appearing *in propria persona*. It is difficult to determine from his brief exactly all of the points he is attempting to make. It appears to the writer of this brief that the questions involved in the appeal are:

- (1) Is the defense of double jeopardy available to the appellant?
- (2) Does the information, which contains seven counts, in fact plead one offense, or does it plead separate offenses subject to consecutive penalties.¹
- (3) Does each of the counts of the information allege a public offense?
- (4) Did the Court impose an excessive penalty?

¹Appellant was sentenced to two years' imprisonment on Counts 1, 2, 3, and 4, each of such terms to run consecutively to the other. Upon Count 5 he was sentenced to a two-year term to run concurrently with Count 1. Upon Count 6 he was sentenced to a two-year term to run concurrently with Count 2. Upon Count 7 he was sentenced to a two-year term to be served at the expiration of sentence on Count 4. The service of this sentence as to Count 7 was suspended and it was ordered that appellant be placed upon probation, the period of probation to commence upon expiration of the sentence to be served as the penalty for Count 4.

IV.

Appellant Has Not Been Placed in Double Jeopardy.

It is true as asserted on pages 1 and 2 of appellant's brief that he entered pleas of guilty in the Superior Court of the State of California in and for the County of San Diego, to three counts of grand theft. The money stolen and involved in the three thefts for which he was prosecuted in the State Court was in each instance money the theft of which was concealed by the false entries pleaded in the information in this case.

It appears that appellant may be asserting that he has been placed in "double jeopardy" because of the prosecution by both State and Federal Governments for the same act and series of acts. However, it is well established that the same act, or series of acts, may constitute an offense against both the State and Federal Governments and draw to its commission the penalties set forth by each as appropriate punishment.²

²Assuming, for discussion, that it was the same act here which was the basis of both State and Federal prosecutions, this objection does not raise the question of jurisdiction of the Court as suggested by appellant, but is a personal privilege which can be waived. *Brady v. U. S.*, 24 F. 2d 399 (C. C. A. 8), 1928. It appears that the appellant herein waived the privilege, if any, by his pleas of guilty to all counts in the information and his failure to raise the question at that time.

Even so, in *U. S. v. Lanza*, 260 U. S. 377, the Court discussed this matter fully and stated:

"It follows that an act denounced as a crime by both national and state sovereignties is an offense against the peace and dignity of both and may be punished by each. The Fifth Amendment, like all the other guaranties in the first eight amendments, applies only to proceedings by the Federal Government, *Barron v. Baltimore*, 7 Pet. 243, and the double jeopardy therein forbidden is a second prosecution under au-

V.

Each of the Counts of the Information Charged a Separate and Distinct Offense.

The appellant alleges that each of the seven counts of the information with which he was charged was predicated upon one typewritten report of cash items and there being but one report, he could be charged with but one count, and that the Court committed error in sentencing appellant upon more than one count. It appears that appellant is including in his brief material in regard to office procedure which cannot be considered by this Court on appeal as it is not supported by the record. Since appellant pleaded guilty to all counts in the information, the Court

thority of the Federal Government after a first trial for the same offense under the same authority."

The Court went on to quote with approval language used in *Southern Railway Company v. Railroad Commission of Indiana*, at page 445:

"In support of this position numerous cases are cited, which like *Cross v. North Carolina*, 132 U. S. 131, hold that the same act may constitute a criminal offense against two sovereignties, and that punishment by one does not prevent punishment by the other. That doctrine is thoroughly established."

The Court concluded its opinion by stating that:

"But it is not for us to discuss the wisdom of legislation, it is enough for us to hold that, in the absence of special provision by Congress, conviction and punishment in a state court under a state law for making, transporting and selling intoxicating liquors is not a bar to a prosecution in a court of the United States under the federal law for the same acts."

See also *Hudspeth v. Melville*, 127 F. 2d 373.

It appears that Congress has made no provision to bar prosecution by the Federal Courts for the acts involved herein after punishment by the State for a violation of state law arising out of the same acts.

did not admit evidence as to the details of the crimes committed.

See *Morris v. District of Columbia*, 124 F. 2d 284 (1941), which holds that extra-record evidence referred to in the briefs will not be considered on appeal.

The appellant again has not cited any case construing Title 49, U. S. C. Sec. 20(7)(b), the statute under which he was indicted. In fact, there does not appear to be any reported case dealing with this point under the statute. However, the provisions of Title 12, U. S. C. 592, are so similar to those of the statute involved in this case that the analogy is directly in point.

The Circuit Court of Appeals for this circuit in *Bower v. United States*, 296 Fed. 694, held as follows (Cert. Den. in 266 U. S. 601):

“The statute prohibits the making of any false entry, not the making of a false report, and each such entry constitutes a separate and distinct crime, even though the several entries are made on the same day and contained in the same statement or report.”

In *Morse v. United States*, 174 Fed. 539, the Court, at page 552, said:

“Every entry, therefore, in the books and documents, which asserted that on the day named Miss Wilson borrowed the sum named from the bank, and every entry which undertook to enumerate the property belonging to the bank, and omitted the shares of this stock bought on that day, is a false entry, because it represented as an actual occurrence one which did not exist. or was false in a material part.”

United States v. Adams, 281 U. S. 202, cited by the defendant can be distinguished from the present case. In the *Adams* case, each of the entries, though in different books, related to the same transaction. In the instant case six of the entries were made in the same report, each entry relating to a different transaction, and the seventh entry was placed in a different portion of the records of the carrier and related to a different matter. In the *Adams* case at page 204, the Court said:

“The two entries and reference to the *same transactions*, were based upon the same draft and were the related means of accomplishing a single fraud * * *. But we think that it cannot have been contemplated that the mere multiplication of entries all to the same point and with a single intent should multiply the punishment in *proportion to the complexity of the bookkeeping*.” (Italics supplied.)

United States v. Dalby, 289 U. S. 224, which held that the crime of making false entries by a national bank officer with intent to defraud, includes any entry on the bank's books which is made to represent what is not true with intent either to deceive its officers or to defraud the association. To the same general effect are *Agnew v. United States*, 165 U. S. 36; *United States v. Wilson*, 176 Fed. 806, and *United States v. Mulloney*, 5 Fed. Supp. 77.

In *Bozel v. United States*, 139 F. 2d 153, an analogous situation is found. The Court stated at page 155:

“The test for determining whether the offenses charged in one or more counts of an indictment are identical is whether the facts alleged in one, if of-

ferred in support of the other would sustain a conviction. * * * Where one count requires proof of a fact which the other does not, the offenses charged are not identical.”

The Court went on to say at page 156:

“*The proof of the mailing of the letter to the corporation named in the first count would not sustain a conviction on the second count, and vice versa the mailing of the letter to the corporation named in the second count would not sustain a conviction on the first count. The gist of the offense under the statute in question is the mailing of a letter in the execution of the scheme to defraud. The mailing and the letter itself constitute the corpus delicti. The statute forbids not the general use of the post office for the purpose of carrying out a fraudulent scheme or device, but the depositing in the post office of a letter or the removal of a letter from the post office in furtherance of a fraudulent scheme. Each letter so removed and each letter so deposited is a separate and distinct violation of the statute. * * **” (Italics supplied.)

Appellant cites on the same proposition of law *Krench v. United States*, 42 F. 2d 354, in which the Circuit Court held:

“* * * although it is competent for Congress to create separate and distinct offenses growing out of the same transaction, where it is necessary in proving one offense to prove every essential element of another growing out of the same act, a conviction of the former is a bar to a prosecution for the latter
* * *.”

In the case involved herein proof of the writing of one entry relating to a certain transaction could not be used to prove the writing of another entry relating to a different transaction.

Appellant further cited *Munson v. McClaghry*, 198 Fed. 72, in support of his contentions. However, in *Hos-tetter v. United States*, 16 F. 2d 921, at page 923, the Court stated:

“* * * the United States Supreme Court, in the case of *Morgan v. Devine*, 237 U. S. 632, at page 640, *et seq*, disapproved the case of *Munson v. McClaghry*, and we think both the McClaghry cases in effect overruled.”

In *Morgan v. Devine*, 237 U. S. 632, the United States Supreme Court stated, at page 640:

“But the test is not whether the criminal intent is one and the same and inspiring the whole transaction, but whether separate acts have been committed with the requisite criminal intent and are such as are made punishable by the act of Congress.”

Appellant further contends that the cash items statement is “nothing more than a memoranda written on an ordinary piece of plain white paper which supports the figure as entered on the ‘company monthly balance sheet, passenger account.’” However, in *Kennedy v. United States*, 275 Fed. 182, C. C. A. 4th, 1931, memoranda kept by the car clerk of a railroad company and devised by him as a part of the system of his office were held to be records or memoranda of the carrier.

VI.

Each of the Counts of the Information Alleges a Public Offense.

Appellant is attempting to secure a *de novo* consideration of matters which were not urged upon the trial court and which are not supported in any way by the record. He states in substance that the statute under which he was indicted was enacted to protect the shipper and traveller and since no shipper or traveller suffered any loss as a result of his speculation, there was no violation of the statute by appellant. However, as stated before, the appellant entered pleas of guilty to the charges in the information and therefore there is nothing in the record before this Court supporting the facts set forth by appellant in his brief as to whether or not (1) the Commerce Commission would have received any complaint from any travellers or shippers, (2) no traveler lost any service by the speculations, (3) all services were paid for at the tariff rate as set by the Interstate Commerce Commission (4) proper entries were made and recorded as to the amount paid for the service for each traveller and shipper. It is true that the appellant here is proceeding in this appeal in *forma pauperis* and therefore should be extended every consideration. However, the appellant cannot expect this Court to consider matters alleged in his brief but not apparent in the record.

Morris v. District of Columbia, supra;

Beach v. U. S., 149 F. 2d 837 (1945).

Further, the very words quoted by appellant in support of his contention from the *U. S. v. Fruit Growers Express Co.*, 279 U. S. 363, reveal that "the general object

of the statute was to require that common carriers should keep reliable records of the receipt and expenditures of and for each shipment which was the subject of transportation.” Although the Act may have been intended to be an *ultimate* protection for the shippers, the general object of the statute was a requirement that common carriers should keep reliable records.

In *Kennedy v. U. S.*, *supra*, at page 183, the Court stated:

“The statute evidently was framed to accomplish two distinct purposes: First, that all accounts, records, and memoranda of the carrier, whether prescribed by the Commission or not, should be true and correct; second, to secure uniformity and prevent secret dealing, that the accounts, records, and memoranda prescribed by the Commission should be used exclusively.”

This contention does not raise a question of jurisdiction as in *Knewel v. Egan*, 268 U. S. 442, at 446, the Court stated as follows:

“It is fundamental that a court upon which is conferred jurisdiction to try an offense has jurisdiction to determine whether or not that offense is charged or proved.”

This excerpt was quoted with approval in *Buie v. King*, 137 F. 2d 495, at 500, C. C. A. 8, 1943.

Further, a motion for correction of a sentence may not be resorted to for the correction of errors of law which do not vitiate the judgment.

Bozel v. U. S., *supra*.

VII.

**This Court Does Not Have Power to Modify the
Sentences Imposed.**

Appellant seeks to obtain a review by this Court of the penalties which were imposed. He does not contend that the penalties imposed are greater than those permitted by statute but that the penalties are unduly severe and that the court should not have considered the amount of the money involved in the peculations.

In *U. S. v. Minuse*, 142 F. 2d 388, at 390, C. C. A. 2, 1944, the appellants objected that the sentences imposed were unduly harsh. The court held that where the sentences imposed were permitted by statute, the Circuit Court of Appeals could not review the sentences on this ground.

Conclusion.

It is respectfully submitted that the appeal is without merit and that the judgment of the District Court should be affirmed.

Respectfully submitted,

JAMES M. CARTER,

United States Attorney,

ERNEST A. TOLIN,

Chief Asst. U. S. Attorney,

NORMAN W. NEUKOM,

Asst. U. S. Attorney,

Chief of Criminal Division,

LEILA F. BULGRIN,

Asst. U. S. Attorney,

Attorneys for Appellee.

No. 12078

United States
Court of Appeals
for the Ninth Circuit

WALTER TREPTE and MARGARET TREPTE,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

DEC - 4 1948

PAUL P. O'BRIEN,
CLERK

No. 12078

United States
Court of Appeals
for the Ninth Circuit

WALTER TREPTE and MARGARET TREPTE,
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

GEORGE H. STONE,
MAYNARD J. TOLL,
WILLIAM D. MORRISON.

For Respondent:

JOHN H. PIGG.

Docket No. 12515

WALTER TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 12516

MARGARET TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1946

Nov. 18—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 18—Copy of petition served on General Counsel.

1946

Nov. 18—Request for Circuit hearing in Los Angeles, Calif., filed by taxpayer.

Dec. 31—Answer filed by General Counsel.

1947

Jan. 3—Copy of answer served on taxpayer, Los Angeles, California.

Jan. 22—Copy of answer served on taxpayer, Los Angeles, California. (Revised notice as to address).

Sep. 30—Hearing set Dec. 1, 1947, Los Angeles, California.

Dec. 1-2—Hearing had before Judge Disney on merits. Motion of counsel to consolidate granted. Stipulation as to the facts and appearance of William D. Morrison as counsel filed. Motion to consolidate filed and copies served. Briefs due 1/20/48. Replies due 2/20/48.

Dec. 19—Transcript of hearing 12/1/47 filed.

Dec. 19—Transcript of hearing 12/2/47 filed.

1948

Jan. 16—Motion for extension to 2/23/48 to file brief filed by taxpayer. 1/16/48 Granted both parties to 2/10/48.

Jan. 20—Brief filed by General Counsel.

Feb. 9—Brief filed by taxpayer.

Mar. 9—Reply brief filed by General Counsel.

Mar. 10—Reply brief filed by taxpayer. Copy served.

May 28—Memorandum findings of fact and opinion rendered, Judge Disney. Decision will be

1948

entered for the respondent. 5/28/48 Copy served.

May 28—Decision entered, Judge Disney, Div. 14.

June 25—Motion to vacate decision and for rehearing and reconsideration or revision of decision filed by taxpayer.

June 28—Motion filed June 25, 1948, denied.

Aug. 23—Petition for review by U. S. Court of Appeals for the Ninth Circuit with assignments of error filed by taxpayer.

Aug. 23—Proof of service filed. [1*]

1948

Oct. 4—Copy of joint motion, affidavit in support of motion and certified copy of order from the U. S. Court of Appeals for the Ninth Circuit re consolidation of Dockets 12515 and 12516 and transmission of petitioner's original exhibits 1 and 4 thru 16 and 21; respondent's original exhibits G thru L and joint original exhibits 2-A, 3-A, 17-C, 18-D, 19-E and 20-F fifteen days prior to the hearing and extension to Nov. 16, 1948, to file record on review filed.

Oct. 11—Designation of record filed by taxpayer with acknowledgment of service thereon.

* Page numbering appearing at foot of page of original certified Transcript of Record.

The Tax Court of the United States

Docket No. 12515

WALTER TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, Los Angeles Division, LA:IT:90D:LHP, dated August 23, 1946, and as basis of his proceedings alleges as follows:

1. The petitioner, Walter Trepte, is an individual with principal office at 2001 Kettner Boulevard, San Diego 1, California. The returns for the period herein involved were filed with the Collector for the Sixth District of California.

2. The notice of deficiency (a copy of which, together with statement accompanying same, is attached hereto, marked Exhibit "A" and made a part hereof), [5] was mailed to the petitioner on August 23, 1946.

3. The taxes in controversy are individual income and victory taxes for the calendar years 1942, and 1943, and in the amount of \$23,183.84.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erroneously held:

1. The Trepte Construction Company co-partnership to be ineffective as a partnership for income tax purposes;

2. The assignment duly made by the petitioner of all of his assets, property, business, and income in and to the Golden & Trepte Construction Company, to the Trepte Construction Company to be ineffective;

3. The Partnership Returns of Income for the calendar years 1942, and 1943, of the Trepte Construction Company to be ineffective;

4. The income of the Trepte Construction Company and the Golden & Trepte Construction Company to be the community property income of the petitioner and the petitioner's wife, Margaret Trepte; and

5. The petitioner's two sons, Walter B. Trepte, and Albert Eugene Trepte, did not participate [6] for income tax purposes in the income of the Trepte Construction Company.

(b) In determining the taxable net income of the petitioner for the calendar years 1942, and 1943, the Commissioner erroneously included as income subject to tax the following items:

(1) Taxable Year Ended December 31, 1942

ADDITIONAL INCOME:

(a) Business income	\$ 14,653.68
(b) Partnership income increased	12,484.31

Total additional income.....\$ 27,137.99

EXPLANATION OF ITEMS
(As shown in Statement Exhibit "A")

"(a) The net business income of the Trepte Construction Company has been determined in the amount of \$29,307.36, computed as follows, your community half of which, or \$14,653.68, is added to your income for the reason previously given:

Net income as reported by Trepte Construction Company	\$176,415.67
Less: Income of Golden & Trepte Construction Co. included therein	146,613.31
Operating income	\$ 29,802.36
Less: Salary paid to Walter B. Trepte.....	495.00
Business income adjusted.....	\$ 29,307.36
Your community half of business income.....	14,653.68

(b) In your return you reported partnership income in the amount of \$60,822.35. As the result of the foregoing adjustment, your partnership income has been determined in the amount of \$73,306.66. The increase, or \$12,484.31, is accordingly added [7] to your income.

Your distributive share of the ordinary net income of Golden & Trepte Construction Company.....	\$146,613.31
Your community share (1/2 of \$146,613.31).....	73,306.66
Partnership income reported	60,822.35
Partnership income increased	\$ 12,484.31";

(2) Taxable Year Ended December 31, 1943

ADDITIONAL INCOME:	Income Tax Net Income	Victory Tax Net Income
(a) Net gain from the sale of capital assets increased.....	\$ 190.96	\$ 0.00
(b) Business income	8,126.57	8,126.57
(c) Partnership income increased	5,155.51	5,155.51
Total additional income.....	\$ 13,473.04	\$ 13,282.08

EXPLANATION OF ITEMS

(As shown in Statement Exhibit "A")

“(a) Net gain from the sale of capital assets, reported in your return in the amount of \$1,048.70, is increased by \$190.96 as shown in the following computation:

Net long-term capital gain realized from the sale of equipment by the Trepte Construction Co.....	\$1,550.01
Your community half of the above gain.....	775.01
Net long-term gain from the sale of stock, as shown in your return	150.00
Total net long-term capital gain.....	\$ 925.01
Net short-term capital gain from the sale of land, as shown in your return	314.65
Net gain from the sale of capital assets, adjusted.....	\$1,239.66
Amount reported in your return.....	1,048.70
Net gain from the sale of capital assets, increased.....	\$ 190.96

The increase, or \$190.96, is accordingly added to your income.

(b) The net business income of the Trepte Construction Company has been determined in the amount of \$16,253.14, computed as follows, your community half of which, or \$8,126.57, is added to your income for the reason previously given:

Net income as reported by Trepte Construction Co.....	\$118,030.00
Less: Income of Golden & Trepte Construction Co. included therein	\$ 99,246.86
Operating profit	\$ 18,783.14
Less: Salary paid to Walter B. Trepte.....	2,530.00
Business income adjusted	\$ 16,253.14
Your community half of business income.....	\$ 8,126.57

(c) In your return you reported partnership income in the amount of \$44,467.92. As the result of the foregoing adjustment, your partnership income has been determined in the amount of

8 *Walter Trepte and Margaret Trepte vs.*

\$49,623.43. The increase, or \$5,155.51, is accordingly added to your income.

Your distributive share of the ordinary net income of

Golden & Trepte Construction Company.....	\$99,246.86
Your community share (1/2 of \$99,246.86).....	49,623.43
Partnership income reported	44,467.92

Partnership income increased\$ 5,155.51”

(c) The Commissioner erroneously determined a deficiency of income and victory tax of the petitioner [9] for the year 1943 of \$23,183.84, based on a total additional income for the taxable year ended December 31, 1942, of \$27,137.99; a total additional net income for income tax purposes of \$13,473.03, and a total additional net income for victory tax purposes of \$13,282.08, for the taxable year ended December 31, 1943; as set out in paragraphs (1) and (2) above, and also shown in statement attached hereto, marked Exhibit “A”, and made a part hereof.

(d) The Commissioner erroneously included as community property taxable income of the petitioner and his wife, Margaret Trepte, the income of the Trepte Construction Company, a partnership, exclusive of the income derived from the Golden & Trepte Construction Company, which income has been properly returned as income in the Partnership Return of Income of the Trepte Construction Company for the calendar years 1942, and 1943, and by the erroneous inclusion of this income by the Commissioner, it increased the taxable income of the petitioner the sum of \$14,653.68, for the calendar year 1942, and \$8,126.57, for income and victory tax purposes for the calendar year 1943.

(e) The Commissioner erroneously included as community property taxable income of the petitioner and his wife, Margaret Trepte, the income derived from [10] the Golden & Trepte Construction Company, a partnership, composed of Walter Trepte, petitioner herein, and M. H. Golden, whereas the assets, property, business, and income of the said co-partnership owned by the petitioner had been duly assigned by the petitioner to the Trepte Construction Company, a partnership, and the income therefrom had been properly returned as income in the Partnership Return of Income of the Trepte Construction Company for the respective calendar years 1942, and 1943, and by the erroneous inclusion of the said income by the Commissioner, the taxable income of the petitioner was increased by the sum of \$12,484.31, for the calendar year 1942, and \$5,155.51, for income and victory tax for the calendar year 1943.

(f) In determining the tax set forth in the notice of deficiency, addressed to the petitioner, the Commissioner erred in disregarding the Articles of Co-Partnership, which were made and entered into as of the first day of January, 1942, by and between Walter Trepte (the petitioner herein), Margaret Trepte (the wife of the petitioner), and their two sons, Walter B. Trepte and Albert Eugene Trepte, and computing the income subject to tax of Trepte Construction Company as though it were community property taxable [11] income of the petitioner, and his wife, Margaret Trepte. A copy of said Articles of Co-Partnership is attached hereto, marked Exhibit "B", and made a part hereof.

(g) In determining the tax as set out in the notice of deficiency addressed to the petitioner the Commissioner through error failed to give consideration or recognition to Forms 1065, Treasury Department, United States Partnership Return of Income for the calendar years 1942, and 1943, heretofore filed by the Trepte Construction Company, a partnership, and by so doing erroneously computed the income subject to tax as though it were community property taxable income of the petitioner, and his wife, Margaret Trepte. A copy of each of said Forms 1065, United States Return of Income for the years 1942, and 1943, heretofore filed by the Trepte Construction Company, is attached hereto, marked Exhibit "C" and "D" respectively, and made a part hereof.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Articles of Co-Partnership were made and entered into as of the first day of January, 1942, by and between Walter Trepte, (the petitioner herein), [12] Margaret Trepte (the wife of the petitioner), and their two sons, Walter B. Trepte, and Albert Eugene Trepte, to conduct and do business as the "Trepte Construction Company," and the business operations were conducted and carried on at all times herein mentioned according to the valid and binding Articles of Co-Partnership, which agreement fixes and determines the interests each of the co-partners shall have in the assets of the Trepte Construction Company, and the share each of the said co-partners shall have in the net income or losses as may result from the operations of the business for each calendar year.

A copy of the said Articles of Co-Partnership is attached hereto, marked Exhibit "B", and made a part hereof.

(b) That at the time of the formation of the co-partnership (Trepte Construction Company) namely, as of January 1, 1942, Walter Trepte, the petitioner herein, assigned to the said co-partnership all of the assets, property, and business, subject to all liabilities, which he used to conduct and carry on the business and operations as the Trepte Construction Company, and the petitioner, Walter Trepte, also duly assigned to the said co-partnership all of his interest in and to the assets, property, business, and income, [13] which was one-half interest, in the Golden & Trepte Construction Company, also assigned all joint construction ventures and all profits and losses from said ventures, as well as all outside earnings by reason of his personal efforts.

(c) Walter B. Trepte, and Albert Eugene Trepte, sons of the petitioner, purchased their respective interest in and to the said co-partnership at its full book value, assumed its liabilities, and have received their share of the income of said co-partnership by distribution thereof to the respective co-partners according to the terms of the said Articles of Co-Partnership, which share of the net income and losses to each is:

Walter Trepte	26%
Margaret Trepte	26%
Walter B. Trepte	24%
Albert Eugene Trepte	24%

The said partners' shares of the income under the

terms of the aforesaid Articles of Co-Partnership were paid over to each of the said co-partners and used by each of the said co-partners as his or her sole and separate property.

(d) Each of the said sons, Walter B. Trepte, [14] and Albert Eugene Trepte, co-partners under the Articles of Co-Partnership, have rendered valuable services to the co-partnership, accepted their full share of the responsibility of the management and control of the Trepte Construction Company, and that during such time as Albert Eugene Trepte was a member of the armed forces of the United States he was considered a member of the said co-partnership and justly entitled to his distributive share in the income, and said share was so paid over to him.

(e) The Commissioner failed to recognize or take into consideration the Articles of Co-Partnership, dated January 1, 1942, marked Exhibit "B", and erroneously included in the deficiency statement, marked Exhibit "A", the following items as taxable income to the petitioner: "Business income \$14,653.68," for the taxable year ended December 31, 1942, and "Business income \$8,126.57," for the taxable year ended December 31, 1943; the "Partnership income increased \$12,484.31," for the taxable year ended December 31, 1942; "Partnership income increased \$5,155.51," for the taxable year ended December 31, 1943, whereas, all of the petitioner's share of the assets, property, business, and income of the Golden & Trepte Construction Company had [15] been duly assigned by the petitioner to, and was received by the Co-Partnership (Trepte Construc-

tion Company); that the above amounts are a part of the income of the Trepte Construction Company, which is taxable to each of the co-partners of the Trepte Construction Company as their respective partners' shares of income as returned in Forms 1065, Treasury Department, United States Partnership Return of Income for the calendar years 1942, and 1943, as heretofore filed by the Trepte Construction Company. A copy of each of said Returns is attached hereto, marked Exhibit "C" and "D" respectively, and made a part hereof, and that the said amounts should not be so segregated or determined to be the community property income of the petitioner.

Wherefore, the petitioner prays this Court may hear the proceeding and determine that there is no deficiency due from the petitioner in the sum of \$23,183.84, or any other sum.

/s/ GEORGE H. STONE,
Counsel for Petitioner.

/s/ MAYNARD J. TOLL,
Counsel for Petitioner. [16]

State of California,
County of San Diego—ss.

Walter Trepte, being duly sworn, says that he is the petitioner above named; that he has read the foregoing petition, and is familiar with the statements contained therein, and that the statements

contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

/s/ WALTER TREPTE.

Subscribed and sworn to before me this 31st day of October, 1946.

(Seal) /s/ GLEN H. MUNKELT,
Notary Public in and for the County of San Diego,
State of California.

[Endorsed]: T.C.U.S. Filed Nov. 18, 1946. [17]

[Title of Tax Court and Cause No. 12515.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits the taxes in controversy are individual income and victory taxes for the calendar years 1942 and 1943; denies the remainder of the allegations contained in paragraph 3 of the petition.

4. (a) to (g), inclusive. Denies the allegations of error contained in subparagraphs (a) to (g), and all subdivisions thereof, of paragraph 4 of the petition.

5. (a) to (e), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (e), inclusive, of paragraph 5 of the petition. [18]

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

E. C. CROUTER,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: T.C.U.S. Filed Dec. 31, 1946. [19]

The Tax Court of the United States

Docket No. 12516

MARGARET TREPTE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, Los Angeles Division, LA: IT: 90D: LHP, dated August 23, 1946, and as basis of her proceedings alleges as follows:

1. The petitioner, Margaret Trepte, is an individual with principal office at 2001 Kettner Boulevard, San Diego 1, California. The returns for the period herein involved were filed with the Collector for the Sixth District of California.

2. The notice of deficiency (a copy of which, together with statement accompanying same, is attached hereto, marked exhibit "A" and made a part hereof) [20] was mailed to the petitioner on August 23, 1946.

3. The taxes in controversy are individual income and victory taxes for the calendar years 1942, and 1943, and in the amount of \$29,480.82.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erroneously held:

1. The Trepte Construction Company Copartnership to be ineffective as a partnership for income tax purposes:

2. The assignment duly made by the petitioner of all of his assets, property, business, and income in and to the Golden & Trepte Construction Company, to the Trepte Construction Company to be ineffective;

3. The Partnership Returns of Income for the calendar years 1942, and 1943, of the Trepte Construction Company to be ineffective;

4. The income of the Trepte Construction Company and the Golden & Trepte Construction Company to be the community property income of the petitioner and the petitioner's husband, Walter Trepte; and

5. The petitioner's two sons, Walter B. Trepte, and Albert Eugene Trepte, did not participate [21] for income tax purposes in the income of the Trepte Construction Company.

(b) In determining the taxable net income of the petitioner for the calendar years 1942, and 1943, the Commissioner erroneously included as income subject to tax the following items:

(1) Taxable Year Ended December 31, 1942

ADDITIONAL INCOME:

(a) Business income	\$ 14,653.68
(b) Partnership income increased	16,252.19

Total additional income.....\$ 30,905.87

EXPLANATION OF ITEMS

(As shown in statement Exhibit "A")

"(a) The net business income of the Trepte Construction Company has been determined in the amount of \$29,307.36, computed as follows, your community half of which, or \$14,653.68, is added to your income for the reason previously given:

Net income as reported by Trepte Construction Co.....\$176,415.67
 Less: Income of Golden & Trepte Construction Co.

included therein 146,613.31

Operating income\$ 29,802.36

Less: Salary paid to Walter B. Trepte..... 495.00

Business income adjusted\$ 29,307.36

Your community half of business income.....\$ 14,653.68

(b) In your return you reported partnership income in the amount of \$57,054.46. As the result of the foregoing adjustment, your partnership income has been determined in the amount of \$73,306.65. The increase, or \$16,252.19, is accordingly added [22] to your income.

Your husband's distributive share of the ordinary

net income of Golden & Trepte Construction Co...\$146,613.31

Your community share (1/2 of \$146,613.31)..... 73,306.65

Partnership income reported 57,054.46

Partnership income increased\$ 16,252.19";

(2) Taxable Year Ended December 31, 1943

	Income Tax Net Income	Victory Tax Net Income
ADDITIONAL INCOME:		
(a) Net gain from the sale of capital assets increased	\$ 447.02	\$
(b) Business income	8,126.57	8,126.57
(c) Partnership income increased..	24,643.39	24,643.39
Total additional income	\$ 33,216.98	\$ 32,769.96

EXPLANATION OF ITEMS

(As shown in statement Exhibit "A")

"(a) Net gain from the sale of capital assets, reported in your return in the amount of \$792.63 is increased by \$447.02 as shown in the following computation:

Net long-term capital gain realized from the sale of equipment by the Trepte Construction Co.....	\$1,550.01
Your community half of the above gain.....	775.00
Net long-term gain from the sale of stock, as shown in your return	150.00

Total net long-term capital gain.....	\$ 925.00
Net short-term capital gain from the sale of land, as shown in your return	314.65

Net gain from the sale of capital assets, adjusted.....	\$1,239.65
Amount reported in your return.....	792.63

Net gain from the sale of capital assets, increased.....	\$ 447.02
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The increase, or \$447.02, is accordingly added to your income.

(b) The net business income of the Trepte Construction Company has been determined in the amount of \$16,253.14, computed as follows, your community half of which, or \$8,126.57, is added to your income for the reason previously given:

Net income as reported by Trepte Cnostruction Co.....	\$118,030.00
Less: Income of Golden & Trepte Construction Co. included therein	99,246.86

Operating profit	\$ 18,783.14
Less: Salary paid to Walter B. Trepte.....	2,530.00

Business income adjusted	\$ 16,253.14
Your community half of business income.....	\$ 8,126.57

(c) In your return you reported partnership income in the amount of \$24,980.04. As the result of the foregoing adjustment, your partnership income has been determined in the amount of \$49,623.43. The increase, or \$24,643.39, is accordingly added to your income.

Your husband's distributive share of the ordinary net income of Golden & Trepte Construction Co.....	\$99,246.86
Your community share (1/2 of \$99,246.86)	49,623.43
Partnership income reported	24,980.04

Partnership income increased	\$24,643.39''
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(c) The Commissioner erroneously determined a deficiency of income and victory tax of the petitioner [24] for the year 1943 of \$29,480.82; based on a total additional income for the taxable year ended December 31, 1942, of \$30,905.87; a total additional net income for income tax purposes of \$33,216.98; and a total additional net income for victory tax purposes of \$32,769.96 for the taxable year ended December 31, 1943, as set out in paragraph (1) and (2) above, and also shown in statement attached hereto, marked exhibit "A", and made a part hereof.

(d) The Commissioner erroneously included as community property taxable income of the petitioner and her husband, Walter Trepte, the income of the Trepte Construction Company, a partnership, exclusive of the income derived from the Golden & Trepte Construction Company, which income had been properly returned as income in the Partnership Return of Income of the Trepte Construction Company for the calendar years 1942, and 1943, and by the erroneous inclusion of this income by the Commissioner, it increased the taxable income of the petitioner the sum of \$14,653.68 for the calendar year 1942, and \$8,126.57 for income and victory tax purposes for the calendar year 1943.

(e) The Commissioner erroneously included as community property taxable income of the petitioner and her husband, Walter Trepte, the income derived from [25] the Golden & Trepte Construction Company, a partnership, composed of Walter

Trepte, and M. H. Golden, whereas the assets, property, business, and income of the said co-partnership had been duly assigned to the Trepte Construction Company, a partnership, and the income therefrom had been properly returned as income in the Partnership Return of Income of the Trepte Construction Company for the respective calendar years 1942, and 1943, and by the erroneous inclusion of the said income by the Commissioner, the taxable income of the petitioner was increased by the sum of \$16,252.19, for the calendar year 1942, and \$24,643.39, for income and victory tax for the calendar year 1943.

(f) In determining the tax set forth in the notice of deficiency, addressed to the petitioner, the Commissioner erred in disregarding the Articles of Co-Partnership, which were made and entered into as of the first day of January, 1942, by and between Margaret Trepte (the petitioner herein), Walter Trepte (the husband of the petitioner), and their two sons, Walter B. Trepte and Albert Eugene Trepte, and computing the income subject to tax of Trepte Construction Company as though it were community property taxable [26] income of the petitioner, and her husband, Walter Trepte. A copy of said Articles of Co-Partnership is attached hereto, marked exhibit "B", and made a part hereof.

(g) In determining the tax as set out in the notice of deficiency addressed to the petitioner the Commissioner through error failed to give consideration or recognition to Forms 1065, Treasury

Department, United States Partnership Return of Income for the calendar years 1942, and 1943, heretofore filed by the Trepte Construction Company, a partnership, and by so doing erroneously computed the income subject to tax as though it were community property taxable income of the petitioner, and her husband, Walter Trepte. A copy of each of said Forms 1065, United States Return of Income for the years 1942, and 1943, heretofore filed by the Trepte Construction Company, is attached hereto, marked exhibit "C" and "D" respectively, and made a part hereof.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Articles of Co-Partnership were made and entered into as of the first day of January, 1942, by and between Margaret Trepte (the petitioner herein), [27] Walter Trepte (the husband of the petitioner), and their two sons, Walter B. Trepte, and Albert Eugene Trepte, to conduct and do business as the "Trepte Construction Company," and the business operations were conducted and carried on at all times herein mentioned according to the valid and binding Articles of Co-Partnership, which agreement fixes and determines the interests each the co-partners shall have in the assets of the Trepte Construction Company and the share each of the said co-partners shall have in the net income or losses as may result from the operations of the business for each calendar year. A copy of the said Articles of Co-Partnership is attached hereto, marked exhibit "B", and made a part hereof.

(b) That at the time of the formation of the co-partnership (Trepte Construction Company) namely, as of January 1, 1942, Walter Trepte, husband of the petitioner herein, assigned to the said co-partnership all of the assets, property, and business, subject to all liabilities, which he used to conduct and carry on the business and operations as the Trepte Construction Company, and the husband of the petitioner, Walter Trepte, also duly assigned to the said co-partnership all of his interests in and to the assets, [28] property, business, and income, which was a one-half interest, in the Golden & Trepte Construction Company, also assigned all joint construction ventures and all profits and losses from said ventures, as well as all outside earnings by reason of his personal efforts.

(c) Walter B. Trepte, and Albert Eugene Trepte, sons of the petitioner, purchased their respective interest in and to the said co-partnership at its full book value, assumed its liabilities, and have received their share of the income of said co-partnership by distribution thereof to the respective co-partners according to the terms of the said Articles of Co-Partnership, which share of the net income and losses to each is:

Walter Trepte	26%
Margaret Trepte	26%
Walter B. Trepte.....	24%
Albert Eugene Trepte.....	24%

The said partners' shares of the income under the terms of the aforesaid Articles of Co-Partnership were paid over to each of the said co-partners

and used by each of the said co-partners as his or her sole and separate property.

(d) Each of the said sons, Walter B. Trepte, [29] and Albert Eugene Trepte, co-partners under the Articles of Co-Partnership, have rendered valuable services to the co-partnership, accepted their full share of the responsibility of the management and control of the Trepte Construction Company, and that during such time as Albert Eugene Trepte was a member of the armed forces of the United States he was considered a member of the said co-partnership and justly entitled to his distributive share in the income, and said share was so paid over to him.

(e) The Commissioner failed to recognize or take into consideration the Articles of Co-Partnership, dated January 1, 1942, marked exhibit "B", and erroneously included in the deficiency statement, marked exhibit "A", the following items as taxable income to the petitioner: "Business income \$14,653.68," for the taxable year ended December 31, 1942, and "Business income \$8,126.57," for the taxable year ended December 31, 1943; the "Partnership income increased \$16,252.19," for the taxable year ended December 31, 1942; "Partnership income increased \$24,643.39," for the taxable year ended December 31, 1943, whereas, all of the petitioner's share of the assets, property, business, and income of the Golden & Trepte Construction Company had [30] been duly assigned to, and was received by the Co-Partnership (Trepte Construction Company); that the above amounts are a part

of the income of the Trepte Construction Company, which is taxable to each of the co-partners of the Trepte Construction Company as their respective partners' shares of income as returned in Forms 1065, Treasury Department, United States Partnership Return of Income for the calendar years 1942, and 1943, as heretofore filed by the Trepte Construction Company. A copy of each of said Returns is attached hereto, marked exhibit "C" and "D" respectively, and made a part hereof, and that the said amounts should not be so segregated or determined to be the community property income of the petitioner.

Wherefore, the petitioner prays this Court may hear the proceeding and determine that there is no deficiency due from the petitioner in the sum of \$29,480.82, or any other sum.

/s/ GEORGE H. STONE,
Counsel for Petitioner,

/s/ MAYNARD J. TOLL,
Counsel for Petitioner. [31]

State of California,
County of San Diego—ss.

Margaret Trepte, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition, and is familiar with the statements contained therein, and that the statements contained therein are true, except those

stated to be upon information and belief, and that those she believes to be true.

/s/ MARGARET TREPTE.

Subscribed and sworn to before me this 31st day of October, 1946.

(Seal) /s/ GLEN H. MUNKELT,
Notary Public in and for the County of San Diego,
State of California. [32]

[Title of Tax Court and Cause No. 12516.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the taxes in controversy are individual income and victory taxes for the calendar years 1942 and 1943; denies the remainder of the allegations contained in paragraph 3 of the petition.

4. (a) to (g), inclusive. Denies the allegations of error contained in subparagraphs (a) to (g), and all subdivisions thereof, of paragraph 4 of the petition. [33]

5. (a) to (e), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (e), inclusive, of paragraph 5 of the petition.

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

E. C. CROUTER,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: T.C.U.S. Filed Dec. 31, 1946. [34]

The Tax Court of the United States

Docket Nos. 12515, 12516

Walter Trepte, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Margaret Trepte, Petitioner, v. Commissioner of Internal Revenue, Respondent.

George H. Stone, Esq., and Wm. D. Morrison, C.P.A., for the petitioners.

John H. Pigg, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND
OPINION

Disney, Judge: These proceedings, consolidated for hearing and disposition, involve deficiencies in income and victory tax liabilities for the year 1943, as follows:

Petitioner	Docket No.	Deficiency
Walter Trepte	12515	\$23,183.84
Margaret Trepte	12516	29,480.82

The year 1942 is involved in these proceedings by reason of the "forgiveness" feature provided by section 6 of the current Tax Payment Act of 1943, relating to tax for 1942 and 1943. [35]

The issues to be determined are: (1) Did the respondent err in his determination that the business carried on under the name of the Trepte Construction Company during the taxable years was not a bona fide partnership, for income tax purposes, composed of petitioners, Walter Trepte, Margaret Trepte and their two sons and that the

income was community income of Walter Trepte and his wife? (2) Did the respondent err in his determination that the alleged assignment by petitioner, Walter Trepte, to the alleged partnership of Trepte Construction Company, of his interest in the joint venture, known as Golden & Trepte Construction Company is ineffective for income tax purposes?

These cases were submitted on a stipulation of facts and oral testimony. The facts as stipulated are so found. Such parts thereof as it is considered necessary to set forth are included with other facts found from evidence adduced in our

FINDINGS OF FACT

Walter Trepte (hereinafter and sometimes referred to as petitioner) and Margaret Trepte are husband and wife and have resided in San Diego, California, since some time prior to their marriage in 1916. Neither petitioner nor his wife had any property prior to their marriage. All property held by either of them is community property. Income tax returns for the periods here involved were filed with the collector of internal revenue for the sixth district of California, at Los Angeles.

Petitioner's father started in the construction business at San Diego, California, in 1895. From 1910 to 1912, petitioner studied structural design at California School of Mechanical Arts, San Francisco. From 1912 to 1917 he worked for his father; the last two years of this period was spent on a [36] ranch, owned by his father, in the Imperial Valley. In 1917, petitioner's father and a partner,

one Rambo, were conducting the business. At that time petitioner gave his father a note for Rambo's share of the business, after which petitioner and his father conducted the business as a partnership. The note was paid out of petitioner's share of the earnings.

In 1928, petitioner bought his father's interest in that partnership. The dissolution was effected by a property division and a cash settlement. Thereafter, petitioner operated his general contracting business under the name of "Walter Trepte Builder," as a sole proprietorship until the date of the creation of the alleged partnership of Trepte Construction Co. on January 1, 1942.

The business of petitioner's father was commercial and engineering contracting. Petitioner continued in this same field after he acquired the business in 1928. The work is technical in that it requires a knowledge of and skill in construction engineering, material and labor markets for the purpose of submitting bids. Petitioner's architectural engineer education gave him real assistance in this phase of the business.

Some time prior to July 6, 1940, petitioner and one M. H. Golden associated themselves as joint venturers to operate as "Golden-Trepte Construction Co.," (hereinafter sometimes referred to as Golden-Trepte) for the purpose of engaging in contracting work for the Federal Government. Golden-Trepte obtained a large contract from the Navy Department for various types of construction in and around the naval facilities in the San

Diego area. The contract was signed by petitioner and Golden, individually, on July 6, 1940. The contract was approved by the Navy Department on July 11, 1940. The contract, as it originally existed, contemplated construction [37] work in the amount of approximately \$3,500,000. However, it was extended to cover projects which eventually had a cost of about \$21,000,000. Under the contract, Golden-Trepte was required to obtain all material and supply all labor. The projects contemplated by this contract and extensions were completed in 1944. Work was begun in 1940. This contract was not obtained on bid but was negotiated at the request of the Navy.

While engaged on the various projects under the Navy contract, Golden-Trepte also undertook other contract work for various governmental agencies and private corporations, including one fuel-depot project for the Navy which was not included in the above contract. Construction jobs were undertaken for Rohr Aircraft Company, as agent for Defense Plant Corporation, and San Diego Gas & Electric Company. The fuel-depot job and the Rohr Aircraft job had value of approximately \$1,750,000. In addition to these, the Trepte Construction Co. also did work for some customers, particularly the Ryan Aircraft Co. Petitioner had a crew at Ryan from 1939 until the end of the war.

The Navy contract provided that Golden-Trepte should designate a construction superintendent to have complete charge of all work under the contract. It further provided that no person

shall be assigned as superintendent, Chief Engineer, Chief Purchasing Agent, Chief Assistant, or similar position in the field organization or as principal assistant to such persons, until the contracting officer shall approve the qualifications and experience of the person proposed for such assignment. The Rohr contract provided that the "contractor" (Golden-Trepte) shall keep on the job, at all times, a qualified representative, satisfactory to the other contracting party. [38]

Prior to January 1, 1942, petitioner had between 75 and 100 employees in his individual business. Golden-Trepte had about 1,500 employees at the peak, which was reached in December 1941. The foreman and superintendent and others who had technical skills giving them responsibility comprised approximately 10 to 20 per cent of the employees for both organizations.

In the summer of 1941, the Navy contract was extended to include certain construction on San Clemente Island, about 100 miles off the coast of San Diego. Petitioner flew out to the project about once a week; due to fog, it was very hazardous. On an earlier trip the plane had nearly crashed and at that time he and Golden discussed what would become of the Navy contract in the event of one or both of their deaths, so petitioner told Golden that he "had been considering having his sons go into partnership" with him, and that he thought that "they should get one formed" as soon as they could to carry on the business if anything happened to them.

Petitioner discussed the desirability of a "partnership" with his wife and two sons on several occasions and pointed out to them how he had been a "partner with his father" and showed them the advantage of coming into a "business which already had an established name for honesty and integrity." The latter part of 1941, petitioner consulted an attorney about drawing up a partnership agreement, and a written "partnership agreement," effective January 1, 1942, was executed, naming as partners petitioner, his wife and sons, Walter B. Trepte and Albert Eugene Trepte.

A certificate of doing business under a fictitious name, dated May 11, 1942, was filed with the State of California. On April 18, 1942, petitioner and his wife executed an instrument entitled "Declaration of Emancipation of [39] Minor," which purported to free Albert Eugene Trepte from all control by his parents as of January 1, 1942. On April 22, 1947, after he attained his majority, Albert executed an instrument purporting to ratify and confirm his act in executing the document entitled "Articles of Co-Partnership," dated January 1, 1942.

In the preamble, the Articles of Co-Partnership recite as follows:

That, Whereas, Wlater [sic] Trepte has for some time past been conducting a general contracting business in the City of San Diego, California, and also has been conducting a joint venture with M. H. Golden under the name of Golden & Trepte Construction Company, and

Whereas, said M. H. Golden and Walter Trepte in the fall of 1941 agreed among themselves to each form a separate family partnership as of January 1, 1942 for the ownership, management and operation of their respective contracting business and to include in their respective family partnerships the assets, accrued earnings and future earnings of said Golden & Trepte Construction Company, and

Whereas, said Walter Trepte has conveyed to the parties hereto all of his interest in his contracting business and his interest in the assets, accrued earnings and future earnings of said Golen [sic] & Trepte Construction Company, and the parties hereto desire to hold all of said property as co-partners and to operate said contracting business as a co-partnership.

The "Partnership Agreement" provided that petitioner and his wife each have a 26 per cent interest and each of the boys have a 24 per cent interest; that the "company" shall have an existence of 20 years from January 1, 1942; also, the capital of said partnership shall consist of "office equipment, planing mill equipment, trucks, machinery, cash in the bank, accounts receivable, naval air station job equity, being the equity in the partnership assets of Golden & Trepte Construction Company, and all other personal property now used by Walter Trepte in said business and also the good will of said business subject to all the liabilities of said business as of [40] January 1, 1942, which appear on the books of sad Walter Trepte as of said date, as follows:"

ASSETS

Cash in bank	\$ 29,197.68
Accounts Receivable	48,023.52
Work in Progress	29.06
Naval Air Station job equity*	88,458.88
Miscellaneous building material	1,846.81
Fixed equipment cost.....	\$14,147.12
Depreciation	3,510.14
Net	\$ 10,636.98
Total Assets	\$178,192.93

LIABILITIES

Accounts payable	\$ 15,079.36
Notes payable to banks	35,000.00
Reserve for insurance	612.91
Reserve for social security taxes.....	1,145.23
Reserve for North Island Equipment.....	1,600.54
Rental Adjustment	
Total Liabilities	\$ 53,438.04
Net Worth	\$124,754.89

*This item consisted of petitioner's interest in money owed to Golden-Trepte by the United States Navy, for labor and material furnished under the contract.

Each of the sons executed and delivered to his parents a promissory note in the amount of \$29,941.17, the "purchase price" of their respective interests in the alleged partnership.

The agreement provided that petitioner should be general manager of the "Partnership." His duties as manager of the "partnership" were substantially the same as his duties as sole owner of the business before January 1, 1942.

Each "partner" was to share in all profits and losses to the extent of the respective interest of each. The agreement further provided as follows:

* * * After the payment of salaries and certain allowances which shall be fixed from time to time by partners holding a majority interest all profits arising from the operation of said partnership shall be added to the capital of said partnership so long as such a majority interest so decides or in the discretion of the holders of a majority interest may be distributed but any distribution to the partners, Walter B. Trepte and Albert Eugene Trepte, will first be applied upon the payment of any outstanding balance of their notes before distribution be made to them individually.

The agreement provided that deposits to the partnership bank account could be made for the "partnership" by any "partner" or agent of the "partnership." Checks could be drawn on any partnership account by such of the "partners" and their agents as were chosen from time to time by holders of a majority interest.

The agreement further provided:

No partner shall during the continuance of the partnership carry on any business in competition with, or be concerned or interested directly or indirectly in the same kind of business as that carried on by the partnership in the County of San Diego, State of California, without the consent in writing of the other parties hereto, except consent is hereby given to Walter Trepte to carry on the business of Golden & Trepte Construction Company and other partnerships, joint ventures or corporations.

Since the time and efforts of partner Walter

Trepte belong to said family co-partnership, and since the investment in the joint venture of Golden & Trepte Construction Company also belongs to the Trepte Construction Company, such of his time as may be spent on the joint ventures of Golden & Trepte Construction Company shall be considered partnership property and the resulting earnings of the Golden and Trepte joint venture shall be partnership earnings.

That any and all earnings from personal services outside of this family co-partnership shall be given due consideration in allocating partnership profits and losses.

Walter B. Trepte, the son of petitioners herein, and one of the alleged partners, was born in San Diego, California, on November 6, 1918, and was 23 years of age on January 1, 1942. He went through high school, and had [42] one-half year of college work at California State College. Prior to January 1, 1942, the alleged date of the partnership, Walter was employed at various times on his father's construction business. He so worked in the summer of 1935 and 1936, the fall of 1938, the entire years of 1939, and from July of 1940. In 1935 and 1936, he worked as a truck driver. In 1938, he did clerical work as assistant to the bookkeeper and timekeeper. For the remainder of 1940, he was employed by Golden-Trepte in the timekeeping office at the naval facility at North Island. He remained in this position until June 1941, when he went to the job at the Naval fuel depot, for Golden-Trepte. At the fuel depot he

was in charge of personnel and timekeeping, did some bookkeeping and certain security work. He hired and fired employees on the authority of Trepte or Golden. Certain employees, those on an hourly or day-to-day basis, he hired or fired as the need for their services rose or fell. From 1935 through 1941, he was carried on the pay rolls as an employee. His compensation ranged from \$15 per week in the beginning to \$35 per week in 1941 when he worked for Golden-Trepte.

After the formation of the "partnership" on January 1, 1942, Walter B. Trepte worked for Golden-Trepte at the fuel depot. In June or July he went to the Golden-Trepte job at Rohr Aircraft Corporation, and in October or November he went back to the Golden-Trepte job at the Naval Air Station, where he remained until the completion of the contract in October or November of 1943. From October or November 1943, until the middle of 1944, he worked for the "partnership" at Rohr Aircraft, and following that he worked about four months at the Naval Air Station for Golden-Trepte. Since that time he has worked on Trepte Construction Company projects. Prior to January 1, 1942, Walter B. Trepte had never assembled the data necessary to prepare [43] a bid for construction work, though he did help petitioner and estimators employed by petitioner to do so. Between January 1, 1942, and December 31, 1943, he assisted in the same manner. The work Walter B. Trepte performed prior to January 1, 1942, was done under petitioner's supervision. Much of the work after

that date up to December 31, 1943, was also under petitioner's supervision. Some of the work performed during this period was approved by the "officer in charge of the Navy." From January 1, 1942, on, he was paid a regular salary of \$55 per week by Trepte Construction Company. He received extra remuneration from Rohr Aircraft job which was put into the "partnership." For the years 1943, 1944, 1945 and 1946, year-end book-keeping entries were made on books of Trepte Construction Company, purporting to adjust Walter B. Trepte's salary to a basis of \$4,800 per year.

A drawing account was set up in the books of the "partnership" for Walter B. Trepte. His salary was charged to it and also certain other personal expenses, payments made on the note held by his parents, and all withdrawals for payments of Federal and State income taxes. He also had a "capital account" in the books to which was credited his purported original 24 per cent interest and a like proportion of the subsequent profits from the "partnership" for each year. He has seen his drawing and capital accounts each year, but his examination was cursory and for his own information. He is not an accountant though he does understand something about the theory of accounting.

Walter B. Trepte was authorized by the majority-interest partners to sign checks on the accounts of the Trepte Construction Company as provided in the alleged partnership agreement and did sign them. He also signed checks on his father's account while the business was under the name of

[44] Walter Trepte, Builder. Other persons also had authority to sign checks for Trepte Construction Company.

All payments made by Walter B. Trepte on his note, held by his parents, and all payments for Federal and State income taxes were made from profits of the business of Trepte Construction Company.

The construction business requires one having knowledge and experience in order to make bids for jobs, and prior to 1942 petitioner was the only one qualified to do this work, though he hired estimators who prepared estimates which were ultimately approved or disapproved by him. After 1942, the same has generally been true, although since 1941 all or most of the construction work performed by Walter Trepte, builder, has been on Government contract. Walter B. Trepte had no inclination toward that technical end of the business.

Albert Eugene Trepte, son of petitioners herein and one of the alleged partners in Trepte Construction Company, was born September 8, 1925. He was 16 years of age on the date of creation of the alleged partnership. He worked for his father in the construction business in the summer of 1941 at the Naval fuel depot as crewman on a small craft and on a pile driver. In the summer of 1942, he worked on the Ryan Aircraft Company job as an assistant carpenter. On the fuel-depot job he received 75 cents per hour and 85 cents per hour on the Ryan job. He went to summer school in 1943. On February 28, 1944, he was drafted into

the United States Navy and was discharged June 7, 1946. During part of 1946, he worked "down there in a capacity of rustling material." In 1947, he worked in the office taking care of bills. In September 1946, he entered on a course of study in architectural engineering at California State Polytechnic College at San Luis Obispo. This is a two-year course. [45]

The note given by Tlbert Eugene Trepte for his alleged interest in the Trepte Construction Company was paid from profits of the business. The "Company" paid for his personal needs, including clothing, recreation, tuition, school, expenses. It also paid his Federal and State individual income taxes. All of these items were charged against a drawing account in his name on the books of Trepte Construction Company.

In 1942, 1943, 1945 and 1946, petitioner drew \$20,000 per year as salary from the alleged partnership. In 1944, due to decreased business, he drew \$10,000.

Petitioner was reasonably familiar with the various revenue bills of 1940, 1941 and 1942. He was reasonably familiar, from previous experience, with the amount of tax he would have to pay on his profits. He had a certified public accountant audit his books and prepare returns before the "partnership" and the same person performed similar work after the date of the creation of the alleged partnership.

The books (Account No. 293) of Trepte Construction Co. show the following as to withdrawals by Walter B. Trepte: [46]

Year	Note and Interest	Collector of Internal Revenue	Franchise Tax Commission	Checks drawn to Walter B. Trepte	Checks drawn for Walter B. Trepte	Total
1942**	\$	\$	\$	\$ 495.00	\$	\$ 495.00
1943***	11,554.74	14,036.58	776.39	2,085.00	10.30	28,463.01
1944	10,802.38	6,682.24	446.88	.....	7.55	17,939.05
1945	10,500.00	1,740.59	104.38	.....	20.00	12,364.97
1946	.....	24,827.76	638.46	100.00	591.53	26,157.75
1947***	.....	6,727.80	648.21	.....	1,211.11	8,587.12
Total	\$32,857.12	\$54,014.97	\$2,614.32	\$2,680.00	\$1,840.49	\$94,006.90*

* Total discrepancy of \$5,862.37 between stipulation and amount shown in capital account not explained. Discrepancies appear in years 1942-3-4-5-6.

*** First entry other than \$55.00 salary payment—
March 19, 1943.

**** Last entry included here—Sept. 26, 1947.

** The date of the first withdrawal recorded on the books was Nov. 2, 1942.

The books of Trepte Construction Co. show the following as to "capital of Walter B. Trepte:"

Date	Descriptive Particulars	Debits	Credits	Balance
Mar. 31, 1943	Transfers of capital from Walter Trepte.....	\$	\$28,941.17	\$28,941.17
Mar. 31, 1943	Profit and Loss 1942.....	.....	29,665.07	58,606.24
Sept. 18, 1943	Adj. error in previous entry recording share purchased from Walter Trepte.....	.....	1,000.00	59,606.24
Feb. 16, 1944	Closing 1943 entries.....	26,877.05	.....	.....
Feb. 16, 1944	Closing 1943 entries.....	.....	23,664.00	56,393.19
Dec. 30, 1944	Walter B. Trepte withdrawals.....	17,843.71	.....	.....
Dec. 30, 1944	Profit and Loss 1944 Distribution.....	.....	8,336.56	46,886.04
Dec. 31, 1945	Walter B. Trepte withdrawals.....	10,472.65	.....	.....
Dec. 31, 1945	Profit and Loss 1945 Distribution.....	.....	25,389.29	61,802.68
Dec. 31, 1946	Walter B. Trepte withdrawals.....	24,364.00	.....	.....
	Profit and Loss 1946 Distribution.....	.....	25,067.35	62,506.03

The books (Account No. 294) of Trepte Construction Co. show the following as to "withdrawals by Albert Eugene Trepte:"

Year	Note and Interest	Collector of Internal Revenue	Franchise Tax Commission	Checks drawn to Albert Eugene Trepte	Checks drawn for Albert Eugene Trepte	Total
1943*	\$11,554.74	\$12,413.21	\$ 987.11	\$750.00	\$ 5.00	\$25,710.06
1944	10,529.78	5,302.29	346.76	.....	676.88	16,855.71**
1945	10,463.27	52.23	55.65	.....	.....	10,571.15
1946	.....	20,110.97	428.77	500.00	186.23	21,225.97
1947***	.....	4,800.55	417.13	750.00	44.80	6,012.48
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	\$32,547.79	\$42,679.25	\$2,235.42	\$2,000.00	\$ 912.91	\$80,375.37

* First entry recorded on the books—March 27, 1943.

** \$209 unexplained discrepancy between stipulation and amount shown in capital account.

*** Last entry included here—September 3, 1947.

The books of Trepte Construction Co. show the following as to "capital of Albert Eugene Trepte:"

Date	Descriptive Particulars	Debits	Credits	Balance
Mar. 31, 1943	Transfer of capital from Walter Trepte.....	.....	\$28,941.17	\$28,941.17
Mar. 31, 1943	Profit and Loss—1942.....	.....	29,665.07	58,606.24
Sept. 18, 1943	Adj. error in previous entry recording share purchased from Walter Trepte.....	.....	1,000.00	59,606.24
<u>Feb. 16, 1944</u>	Closing 1943 Entries.....	\$25,710.06	.....	.....
Feb. 16, 1944	Closing 1943 Entries.....	.....	23,664.00	57,560.18
Dec. 30, 1944	Albert Eugene Trepte withdrawals.....	16,646.71	.....	.....
Dec. 30, 1944	Profit and Loss 1944 Distribution.....	.....	8,336.56	49,250.03
Dec. 31, 1945	Albert Eugene Trepte withdrawals.....	10,571.15	.....	.....
Dec. 31, 1945	Profit and Loss 1945 Distribution.....	.....	25,389.28	64,068.16
Dec. 31, 1946	Albert Eugene Trepte withdrawals.....	21,225.97	.....	.....
Dec. 31, 1946	Profit and Loss 1946 Distribution.....	.....	25,067.35	67,909.54

Partnership returns of income filed with the collector of internal revenue for the Trepte Construction Co. showed the following in schedule J:

Name	1942	Long	1943	Long
	Ordinary Net Income	Term Gain	Ordinary Net Income	Term Gain
Walter Trepte	\$60,822.35	\$ 686.93	\$44,467.92	\$ 584.05
Margaret Trepte	57,054.46	644.37	24,980.04	327.98
Walter B. Trepte	29,529.06	333.49	25,523.78	335.11
Albert E. Trepte	29,009.80	327.63	23,058.26	302.87
Total.....	\$176,415.67	\$1,992.42	\$118,030.00	\$1,550.01

OPINION

Factually, the first issue in this case follows the now familiar pattern of family partnerships, and is in many respects similar to *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293. Since this case arises in a community property state (California) and there is no serious contention concerning the wife's interest in the business, our consideration will be directed primarily to the alleged interest of the two sons—Walter B. and Albert Eugene.

Petitioner argues "That vital and valuable services were rendered by each of the sons to the co-partnership; that the two sons participated in the control and management of the business; that each of the sons obtained by purchase his partnership interest in the co-partnership, and went into debt to obtain such interest."

As to capital contribution of an alleged partner, the *Tower* case establishes the rule that whether capital contribution to the business originates with the one making the contribution is a factor to be

considered. The wife in the well-known Lusthaus case signed notes and later had the notes paid off out of the earnings of the business. In that case the Supreme Court of the [49] United States concluded that the wife did not invest capital originating with herself. Petitioners' sons have no stronger case than did the wife in the Lusthaus case. The sons signed notes and the notes were retired by the application of earnings from the business, but there was no investment of new capital in the business, i. e., no new capital that was not already available for use in the business.

The Tower case also established the rule for one to be a partner of a so-called "family partnership" from "services" standpoint, that the alleged partner must substantially contribute to the control and management of the business or otherwise perform vital additional services. We, therefore, consider next whether the sons contributed such services as, under the Tower case and others to the same effect, would justify recognition of them as partners. As to Albert Eugene, it is clear, we think, that there was no such service contribution. At the time the "partnership" was created, he was only sixteen years of age. He worked some in the summer of 1941 for petitioner as a crewman on a small craft and on a pile driver, for which he received a small hourly wage. In the summer of 1942, he worked as an assistant carpenter on the Ryan job for an hourly wage of 85 cents. In 1943, he performed no services and in 1944 he entered the United States Navy. He was discharged in

1946 and soon thereafter enrolled in college. It appears that he did not substantially contribute to the control and management of the business or otherwise perform vital additional services. Walter B. is in a different position in that he was older and was earning a salary of \$35 per week before January 1, 1942, and \$55 per week thereafter, but that fact only serves to refute a contribution of such services by him as would support a partnership. He was paid both before and after formation of the [50] alleged partnership for about the same services. For the years 1943, 1944, 1945 and 1946, year-end bookkeeping entries were made on the books of the "partnership", purporting to adjust his salary to a basis of \$4,800 per year. The services he performed were of a clerical nature, including timekeeping, bookkeeping, some personnel work and the like, for which we think he was adequately paid through the compensation he received in the form of salary. Petitioner stated, at the hearing, that Walter B. was his (petitioner's) assistant but produced no evidence as to the date he became such or what his duties were in that capacity. We think, in general, that services do not greatly affect this case. We find neither son adding "vital additional service" which would take the place of capital contributed because of formation of a partnership.

In addition to the above inquiry as to the presence of these elements deemed by the Tower case essential to partnerships recognizable for Federal tax purposes, other facts, in our opinion, compel a conclusion that there is not here presented such

partnership. Looking at all the facts, we can not say that such a partnership was formed January 1, 1942. Petitioner testified that it was a gradual change into a partnership. In our opinion, the partnership either started January 1, 1942, or not at all. The fact that capital accounts were not set up for the sons until March 31, 1943, indicates no partnership on the alleged date of formation, January 1, 1942. The date first appearing on Albert Eugene Trepte's withdrawal account was March 27, 1943, the first on Walter B. Trepte's withdrawal account was November 30, 1942. Though it is claimed by petitioner that the sons had free access to withdraw their share of the profits from the business, the facts presented give us reason to believe otherwise. According to the books presented in this case, [51] there has been added to Walter B. Trepte's capital account \$112,122.27, indicating his share of the profit of the Trepte Construction Company for the years 1942 to 1946, inclusive. His withdrawals (including September 26, 1947) have been approximately \$94,006.90. Of this amount, \$2,680 was indicated as "checks drawn to Walter B. Trepte" and \$1,840.49 as "checks drawn for Walter B. Trepte." The remainder of the \$94,006.90 was for "Note and interest," "Collector of Internal Revenue" and "Franchise Tax Comm." In like manner there has been added to Albert Eugene Trepte's capital account \$112,122.26 as his share of the profit from the Trepte Construction Company. His withdrawals (including September 3, 1947) have been approximately \$80,375.37, of this

amount, \$2,000 was indicated as "Checks drawn to Albert Eugene Trepte" and \$912.91 as "checks drawn for Albert Eugene Trepte." The remainder of the \$80,375.37 was for "notes and interest," "Collector of Internal Revenue" and "Franchise Tax Comm." There is nothing in the record to indicate that the sons exercised any freedom in regard to withdrawal of their share of the profits. This is not only true of the years 1942 and 1943, but the years following.

Neither does the partnership agreement indicate a true partnership. The agreement provides that the profits and losses are to be divided as follows: 26 per cent to petitioner, 26 per cent to his wife, and 24 per cent to each son. However, the following statement appears in paragraph 11 of the agreement:

That any and all earnings from personal services outside of this family co-partnership shall be given due consideration in allocating partnership profits and losses.

The conflict raises doubt in our minds as to the real intention of the operation of the business in this regard. [52]

The partnership agreement further provides that petitioner should be general manager of the "Partnership." There is no indication that the sons or wife were to take any active part in the operation of the business. Rather, the contrary appears to be true that petitioner would continue to "run" the business as before January 1, 1942.

The lack of reality of a true partnership is further demonstrated in the fact that petitioner's wife, Margaret Trepte, is one of the alleged partners, yet there is no showing whatsoever of contributed capital or services on her part, as required by the Tower case. There is no showing of any business activity on her part in connection with the "Partnership." We consider the lack of facts in this regard important in our consideration of the reality of the "Partnership," i. e., whether the four members of the family really intended to operate as a partnership. We believe they did not.

Petitioner's reliance on such cases as Walter J. Runyon, 8 T. C. 350, and William F. Fischer, 5 T. C. 507, is of no avail since they are clearly distinguishable for the instant proceeding.

As to the partnership question, we therefore, hold for the respondent. In view of our conclusion it becomes unnecessary to consider the second issue.

Decision will be entered for the respondent.

Entered May 28, 1948.

[53]

The Tax Court of the United States

Washington

Docket No. 12515

WALTER TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, entered May 28, 1948, it is

Ordered and Decided: That there is a deficiency in income and victory tax of \$23,183.84 for the year 1943.

/s/ R. L. DISNEY,

Judge.

Entered May 28, 1948.

[54

The Tax Court of the United States

Washington

Docket No. 12516

MARGARET TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, entered May 28, 1948, it is

Ordered and Decided: That there is a deficiency in income and victory tax of \$29,480.82 for the year 1943.

/s/ R. L. DISNEY,
Judge.

Entered May 28, 1948.

[55]

In the United States Circuit Court of Appeals
For the Ninth Circuit

T. C. Docket No. 12515

WALTER TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

T. C. Docket No. 12516

MARGARET TREPTE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION TO REVIEW DECISIONS OF THE
TAX COURT OF THE UNITED STATES

To the Honorable, the Judges of the United States
Circuit Court of Appeals for the Ninth Circuit:

Walter Trepte and Margaret Trepte, husband and wife, the petitioners in these causes, by George H. Stone and Wm. D. Morrison, counsel, hereby file their petition for a review by the United States Circuit Court of Appeals for the Ninth Circuit of the Memorandum Findings of Fact and Opinion, and Decisions by The Tax Court of the United States entered May 28, 1948, Docket Nos. 12515 and 12516, determining deficiencies in the petition-

ers' United States individual income taxes for the calendar years 1942 and 1943 as follows:

Petitioner	Docket No.	Deficiency
Walter Trepte	12515	\$23,183.84
Margaret Trepte	12516	29,480.82

and respectfully show:

I.

Venue

This petition for review is filed pursuant to provisions [56] of sections 1141 and 1142 of the Internal Revenue Code.

The petitioners, Walter Trepte and Margaret Trepte, each filed his or her Forms 1040, United States Individual Income Tax Returns for the calendar years 1942 and 1943 with the Collector of Internal Revenue of the Sixth District of California, which district includes the County of San Diego, the residence of the petitioners; that subsequent to the decisions of The Tax Court of the United States, rendered May 28, 1948, the petitioners, in lieu of bond or undertaking, and to stop interest from accruing in connection with the deficiencies claimed, paid to the aforesaid Collector the sum of \$52,664.66 taxes, together with interest in the sum of \$13,516.11, making a total of \$66,-180.77.

II.

Nature of the Controversy

On November 18, 1946, each of the petitioners herein filed with The Tax Court of the United

States, pursuant to the provisions of the Internal Revenue Code, his or her petition requesting the redetermination of the deficiency of his or her United States individual income and victory taxes for the calendar years 1942 and 1943 as shown by the official notice of the deficiency mailed by the respondent to each of the aforesaid petitioners under date of August 23, 1946, as follows:

Years 1942 and 1943, Walter Trepte,	
Income and Victory Tax.....	\$23,183.84
Years 1942 and 1943, Margaret Trepte,	
Income and Victory Tax.....	\$29,480.82

The respondent filed his answers December 31, 1946, admitting the jurisdictional facts, but generally denying all of the other allegations of each of the petitions.

The petitions to The Tax Court of the United States of each of the petitioners herein allege that:

(a) Articles of co-partnership were made and entered into as of the first day of January, 1942, by and between Walter Trepte, Margaret Trepte, and their two sons, Walter B. Trepte and Albert Eugene Trepte, to conduct and do business as the "Trepte Construction Co.," and the business operations were conducted and carried on at all times herein mentioned according to the valid and binding Articles of Co-partnership, which agreement fixes and determines the interests each of the co-partners shall have in the assets of the Trepte Construction Co., and the share each of the said co-partners shall have in the net income or losses as

may result from the operations of the business for each calendar year.

(b) That at the time of the formation of the co-partnership (Treppe Construction Co.) namely, as of January 1, 1942, Walter Treppe, the petitioner herein, assigned to the said co-partnership all of the assets, property, and business, subject to all liabilities, which he used to conduct and carry on the business and operations as the Treppe Construction Co., and the petitioner, Walter Treppe, also duly assigned to the said co-partnership all of his interest in and to the assets, property, business and income, which was one-half interest, in the Golden & Treppe Construction Company, also assigned all joint construction ventures and all profits and losses from said ventures, as well as all outside earnings by reason of his personal efforts.

(c) Walter B. Treppe and Albert Eugene Treppe, sons of the petitioners, purchased their respective interest in and to the said co-partnership at its full book value, assumed its liabilities, and have received their share of the income of said co-partnership by distribution thereof [58] to the respective co-partners according to the terms of the said Articles of Co-partnership, which share of the net income and losses to each is:

Walter Treppe	26%
Margaret Treppe	26%
Walter B. Treppe	24%
Albert Eugene Treppe	24%

The said partners' shares of the income under the

terms of the aforesaid Articles of Co-partnership were paid over to each of the said co-partners and used by each of the said co-partners as his or her sole and separate property.

(d) Each of the said sons, Walter B. Trepte and Albert Eugene Trepte, co-partners under the Articles of Co-partnership, have rendered valuable services to the co-partnership, accepted their full share of the responsibility of the management and control of the Trepte Construction Co., and that during such time as Albert Eugene Trepte was a member of the armed forces of the United States he was considered a member of the said co-partnership and justly entitled to his distributive share in the income, and said share was so paid over to him.

(e) The Commissioner failed to recognize or take into consideration the Articles of Co-partnership, dated January 1, 1942, marked Exhibit "B" (Petitioners' Exhibit 1), and erroneously included in the deficiency statement, marked Exhibit "A" ((Petitioners' Exhibits 4 and 5), the following items as taxable income to each of the petitioners herein:

As to petitioner, Walter Trepte:

"Business income \$14,653.68," for the taxable year ended December 31, 1942, and "Business income \$8,126.57," for the taxable year ended December 31, 1943; the "Partnership [59] income increased \$12,484.31," for the taxable year ended December 31, 1942; "Partnership income increased \$5,155.51," for the taxable year ended December 31, 1943;

As to petitioner, Margaret Trepte:

“Business income \$14,653.68,” for the taxable year ended December 31, 1942, and “Business income \$8,126.57,” for the taxable year ended December 31, 1943; the “Partnership income increased \$16,252.19,” for the taxable year ended December 31, 1942; “Partnership income increased \$24,643.39,” for the taxable year ended December 31, 1943;

whereas, all of the petitioner's, Walter Trepte, share of the assets, property, business, and income of the Golden & Trepte Construction Company had been duly assigned by the petitioner, Walter Trepte, to, and was received by, the co-partnership (Trepte Construction Co.); that the above amounts are a part of the income of the Trepte Construction Co., which is taxable to each of the co-partners of the Trepte Construction Co. as their respective partners' shares of income as returned in Forms 1065, Treasury Department, United States Partnership Returns of Income for the calendar years 1942 and 1943, as heretofore filed by the Trepte Construction Co.

The Commissioner of Internal Revenue held the Articles of Co-partnership of January 1, 1942, to be ineffective for income tax purposes and the income reported on the returns of the said partners for the calendar years 1942 and 1943 were adjusted by the Commissioner and held to be the community property of Walter Trepte and his wife, Margaret Trepte; whereas, the income as shown by the part-

nership returns was the income of Walter Trepte, Margaret Trepte, husband and wife, and their two sons, Walter B. Trepte and Albert Eugene [60] Trepte, pursuant to the co-partnership agreement of January 1, 1942.

The Commissioner determined that the income from the Golden & Trepte Construction Company was the community income of Walter Trepte and his wife, Margaret Trepte; whereas, the income from the Golden & Trepte Construction Company was a source of income to the Trepte Construction Company as Walter Trepte had, at the time of the creation of the Articles of Co-partnership, duly assigned to the Trepte Construction Company all of his assets, property, business and earnings in the Golden & Trepte Construction Company, which was one-half interest.

On December 1 and 2, 1947, the causes were heard before Honorable Richard L. Disney, Judge of the Tax Court of the United States, sitting at Los Angeles, California. Petitioners and respondent each filed an opening brief and each filed a reply brief and the causes were submitted for decision. The Tax Court of the United States rendered its Memorandum Findings of Fact and Opinion May 28, 1948, and final Orders and Decisions were duly entered on May 28, 1948, finding deficiencies as set forth above.

III.

Designation of Court of Review

The said petitioners, being aggrieved by the Memorandum Findings of Fact and Opinion, and

Orders and Decisions of the Tax Court of the United States, desire a review thereof, in accordance with the provisions of the Internal Revenue Code, by the United States Circuit Court of Appeals for the Ninth Circuit, within which Circuit is located the office of the Collector of Internal Revenue to whom the said petitioners made their income tax returns for the calendar years 1942 and 1943. [61]

IV.

Assignments of Error

Now comes the petitioners, Walter Trepte and Margaret Trepte, and assign as error in the Memorandum Findings of Facts and Opinion, and Orders and Decisions, the following acts and omissions of the Tax Court of the United States:

(1) The findings of the Tax Court are not supported by the evidence;

(2) The failure to hold that the Articles of Co-partnership of the Trepte Construction Co., dated January 1, 1942, were effective as of said date and constituted a bona fide partnership for tax purposes;

(3) The failure to find that the petitioner, Margaret Trepte, and each of the sons of the said petitioner, Walter B. Trepte and Albert Eugene Trepte, contributed capital to the said co-partnership;

(4) The failure to hold that each of the said sons, Walter B. Trepte and Albert Eugene Trepte, contributed vital services to the co-partnership;

(5) The failure to find that each of the said sons,

Walter B. Trepte and Albert Eugene Trepte, had a share in the management and control of the business;

(6) The failure to determine that there was a definite relation between the profits allocated to each partner and the value of the services rendered;

(7) The failure to find that there was no casting about for a legal means of lessening the tax;

(8) The failure to find that the formation of the present co-partnership by and between the members of the Trepte family constituted a bona fide co-partnership for tax and all other purposes of the third generation of the Trepte family who have constantly carried on the integrity [62] and good will of the construction business under the Trepte name;

(9) The failure to find that Walter B. Trepte and Albert Eugene Trepte each had his share of the profits derived from the partnership; each had control of his share of the profits; and each son had the right to withdraw his share of the profits without being hampered by his parents in any way;

(10) The failure to hold that the partnership did all things necessary and requisite to constitute a partnership as provided for by the laws of the State of California, and by the Internal Revenue Code, more specifically Sections 181, 182, 183, 187 and 3797;

(11) The finding of deficiencies for the years 1942 and 1943 in lieu of a determination that there is no income tax due from the petitioners, Walter Trepte and Margaret Trepte, for either of the years in controversy;

(12) The Tax Court of the United States erred in rendering its decisions for respondent.

Wherefore, petitioners pray that said errors be corrected and the judgment and findings of said Tax Court be reversed.

/s/ WALTER TREPTE,
Petitioner.

/s/ MARGARET TREPTE,
Petitioner.

/s/ GEORGE H. STONE,
Counsel for Petitioner.

/s/ WM. D. MORRISON,
Counsel for Petitioner.

(Affidavits of Verification attached.)

[Endorsed]: T.C.U.S. Filed Aug. 23, 1948. [64]

[Title of U. S. Court of Appeals and Causes.]

NOTICE OF FILING PETITION TO REVIEW
DECISIONS OF THE TAX COURT OF
THE UNITED STATES

To: Commission of Internal Revenue, Internal Revenue Building, Washington, D. C.; Charles Oliphant, Attorney for Respondent, Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that the petitioners, Walter Treppe and Margaret Treppe, on the 23rd day of August, 1948, filed with the Clerk of The Tax

Court of the United States, Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decisions of The Tax Court of the United States heretofore rendered in the above-entitled causes. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated at San Diego, California, this 23rd day of August, 1948.

Respectfully,

/s/ GEORGE H. STONE,
Counsel for Petitioner.

/s/ WM. D. MORRISON,
Counsel for Petitioner.

(Acknowledgment of Service.)

[Endorsed]: T.C.U.S. Filed Aug. 23, 1948. [66]

The Tax Court of the United States

Docket Nos. 12515 and 12516

WALTER TREPTE and MARGARET TREPTE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STIPULATION OF FACTS

It is hereby stipulated by and between the above-entitled Petitioners and the Commissioner of Internal Revenue, by their respective and undersigned attorneys, that the following facts may be accepted as true reserving to either party the right to introduce any proper evidence not inconsistent therewith:

FACTS

1. The petitioner, Walter Treppe, is an individual with a principal office at 2001 Kettner Boulevard, San Diego, California.

2. The petitioner, Margaret Treppe, is the wife of the petitioner, Walter Treppe, and resides with him at 736 Rosecrans, San Diego, California.

3. For many years prior to January 1, 1942, petitioner, Walter Treppe, was doing a general contracting and construction business in San Diego County, California, the business and its assets being the community property of him and his wife, Margaret Treppe. [67]

4. As of January 1, 1942, Walter Treppe and

Margaret Trepte, the petitioners herein, and Walter B. Trepte and Albert Eugene Trepte, their sons, executed a document entitled "Articles of Co-partnership," a photostatic copy whereof may be received in evidence as petitioner's Exhibit 1.

5. Walter B. Trepte, the son of petitioners, Walter Trepte and Margaret Trepte, was born November 6, 1918, and is, therefore, 29 years of age.

6. Albert Eugene Trepte, the son of petitioners, Walter Trepte and Margaret Trepte, was born September 8, 1925, and is, therefore, 22 years of age.

7. Partnership return of said Trepte Construction Company for the year 1942 was filed with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 2-A.

8. Partnership return of said Trepte Construction Company for the year 1943 was filed with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 3-B.

9. Letter and deficiency statement from Commissioner of Internal Revenue was mailed to petitioner, Walter Trepte, on August 23, 1946, which letter and statement of deficiency may be received in evidence as petitioner's Exhibit 4.

10. Letter and deficiency statement from Commissioner of Internal Revenue was mailed to petitioner, Margaret Trepte, on August 23, 1946, which letter and statement of deficiency may be received in evidence as petitioner's Exhibit 5. [68]

11. Walter Trepte and Margaret Trepte, parents

of Albert Eugene Trepte, on April 18, 1942, executed an instrument entitled "Declaration of Emancipation of Minor," which may be received in evidence as petitioner's Exhibit 6.

12. Said Albert Eugene Trepte did, on April 22, 1947, after he was of age, execute an instrument purporting to ratify and confirm his act in execution of the document entitled "Articles of Copartnership," Joint Exhibit 1—which may be received in evidence as petitioner's Exhibit 7.

13. The original of a document purporting to be a note executed by Albert Eugene Trepte to Walter Trepte and Margaret Trepte, dated January 1, 1942, for \$29,941.17, with the endorsements thereon, may be received in evidence as petitioner's Exhibit 8.

14. The original of a document purporting to be a note executed by Walter B. Trepte to Walter Trepte and Margaret Trepte, dated January 1, 1942, for \$29,941.17, with the endorsements thereon, may be received in evidence as petitioner's Exhibit 9.

15. The payroll record of payments to Walter B. Trepte on the payroll sheets of Walter Trepte for July 5, 12 and 25th and August 2, 9, 16, 23, and 30th, 1935, and July 9, 16, 23 and 30th and August 7, 14, and 20th, 1936, may be received in evidence as Petitioner's Exhibit 10. [69]

16. The Employees Account record of Walter B. Trepte from the books of Walter Trepte for the years 1937, 1938, 1939, 1940, 1941 and 1942, photostatic copy of which may be received in evidence as petitioner's Exhibit 11.

17. Photostatic copies of the Employees Account record of Albert Eugene Trepte from the books of Walter Trepte for the year 1941 and Trepte Construction Company for the year 1942 may be received in evidence as petitioner's Exhibit 12.

18. Photostatic copy of five ledger sheets of Account No. 293 captioned "Walter B. Trepte Withdrawals" of the books of account of Trepte Construction Company, being ledger sheet for 1942 and sheet No. 1 for 1943 and Nos. 1, 2 and 3 from December 1943 to and including October 8, 1947, may be received in evidence as petitioner's Exhibit 13.

19. Cancelled checks of Trepte Construction Company of date, number, payee and amount as follows are the paid vouchers for expenditures in Account No. 293, Exhibit 13:

Date	Number	Payee	Amount
11/ 2/42	4504X	Walter B. Trepte	\$ 55.00
11/ 9/42	4518X	Walter B. Trepte	55.00
11/19/42	4585X	Walter B. Trepte	110.00
11/28/42	4590X	Walter B. Trepte	55.00
12/ 4/42	4597Y	Walter B. Trepte	55.00
12/19/42	4655Y	Walter B. Trepte	110.00
12/28/42	4661Y	Walter B. Trepte	55.00
1/ 2/43	4665Z	Walter B. Trepte	55.00
1/ 9/43	4722Z	Walter B. Trepte	55.00
1/25/43	5009Z	Walter B. Trepte	165.00
1/30/43	5016Z	Walter B. Trepte	55.00
2/ 5/43	5027	Walter B. Trepte	55.00
2/12/43	6009	Walter B. Trepte	55.00
2/22/43	6025	Walter B. Trepte	55.00
2/26/43	6037	Walter B. Trepte	55.00
3/ 6/43	6057	Walter B. Trepte	55.00
3/12/43	6125	Walter B. Trepte	55.00
3/19/43	6141	Walter B. Trepte	50.00
3/26/43	6154	Walter B. Trepte	55.00
3/15/43	6131	U. S. Collector of Int. Rev.....	3,509.15

Date	Number	Payee	Amount
4/ 3/43	8	Walter B. Trepte	55.00
4/ 9/43	19	Walter B. Trepte	55.00
4/16/43	100	Walter B. Trepte	55.00
4/ 7/43	13	California State Treasurer.....	388.19
4/23/43	108	Walter B. Trepte	55.00
4/30/43	119	Walter B. Trepte	55.00
5/ 7/43	125	Walter B. Trepte	55.00
5/14/43	217	Walter B. Trepte	55.00
5/21/43	228	Walter B. Trepte	55.00
5/28/43	241	Walter B. Trepte	55.00
6/10/43	279	Mission Florists	10.30
6/ 3/43	248	Walter B. Trepte	55.00
6/11/43	303	Walter B. Trepte	55.00
6/12/43	306	Collector of Internal Revenue.....	3,509.15
6/17/43	322	Walter B. Trepte	55.00
6/24/43	335	Walter B. Trepte	55.00
7/ 2/43	348	Walter B. Trepte	55.00
7/ 9/43	410	Walter B. Trepte	55.00
7/15/43	429	Walter B. Trepte	55.00
7/22/43	443	Walter B. Trepte	55.00
7/30/43	455	Walter B. Trepte	55.00
8/ 5/43	466	Walter B. Trepte	55.00
8/12/43	547	California State Treasurer	388.19
8/13/43	551	Walter B. Trepte	55.00
8/20/43	562	Walter B. Trepte	55.00
8/26/43	573	Walter B. Trepte	55.00
9/ 2/43	586	Walter B. Trepte	55.00
9/ 9/43	590	Walter B. Trepte	55.00
9/13/43	680	Collector of Internal Revenue.....	3,509.14
9/16/43	696	Walter B. Trepte	6,554.74
12/10/43	1017	U. S. Collector of Int. Rev.....	3,509.14
12/10/43	1021	Franchise Tax Commissioner	388.20
12/21/43	1041	Walter B. Trepte	5,000.00
3/13/44	1377	U. S. Collector of Int. Rev.....	2,602.24
4/11/44	1510	State Treasurer	446.88
4/11/44	1513	Collector of U. S. Int. Rev.....	710.00
6/12/44	1813	Collector of U. S. Int. Rev.....	1,420.00
7/13/44	F	County Treasurer	42.34
7/21/44	1984	Walter B. Trepte	5,302.38
9/ 8/44	2708	Collector of U. S. Int. Rev.....	1,950.00
12/21/44	2446	Walter B. Trepte	5,500.00

Date	Number	Payee	Amount
3/10/45	3646	Franchise Tax Commissioner	104.38
6/ 4/45	4200	Collector of U. S. Int. Rev.....	840.59
9/ 4/45	4758	Collector of U. S. Int. Rev.	900.00
10/26/45	5086	John M. Hotaling	23.84
12/28/45	5455	Walter B. Trepte	10,500.00
1/11/46	5589	Collector of U. S. Int. Rev.	13,000.00
3/23/46	6036	San Diego Wholesale Supply Co.	80.46
3/29/46	6058	Franchise Tax Commissioner	638.46
4/26/46	6274	Concord Radio Corp.	17.66
5/23/46	6473	New York Life Insurance Co.....	301.00
6/10/46	6625	Collector of U. S. Int. Rev.	1,227.76
6/24/46	6682	Railway Express Agency	22.44
7/15/46	6846	Walter B. Trepte	100.00
7/18/46	6864	J. M. Hotaling	18.74
7/24/46	6883	Asbestos Products Co.....	33.95
8/23/46	7117	Concord Radio Corp.	15.85
9/11/46	7283	Collector of U. S. Int. Rev.	1,700.00
9/25/46	7363	Hotel Plaza, San Francisco, Cal.	6.00
11/19/46	7747	Clarion Sound Engineering Co...	97.50
12/31/46	7989	Collector of U. S. Int. Rev.....	8,900.00
1/24/47	8151	Clarion Sound Engineering Co...	11.00
1/27/47	A	D. G. King	161.75
2/ 9/47	B	Don G. King	165.79
3/ 5/47	8439	Thearle Music Co.	577.31
3/11/47	8525	Collector of U. S. Int. Rev.	847.80
3/27/47	8571	Franchise Tax Commissioner.....	648.21
4/ 2/47	8594	New York Life Insurance Co.....	391.40
5/17/47	C	Julio Alvarez	10.00
5/28/47	8964	Bekins Van & Storage Co.....	26.74
6/ 6/47	9016	Wright Refrigeration Inc.	60.00
6/ 6/47	9033	Collector of U. S. Int. Rev.....	2,940.00
7/23/47	9331	Precision Radio	144.15
7/24/47	D	M. R. Montgomery	12.00
9/ 2/47	9516	Collector of U. S. Int. Rev.....	2,940.00
9/15/47	9643	L. E. Behymer	50.00
9/13/47	E	The Music Den	92.70
9/26/47	9664	Cash	50.00

20. Photostatic copy of four ledger sheets of Account No. 294 captioned "Albert Eugene Trepte Withdrawals" of the books of account of Trepte

Construction Company, being ledger sheet for 1943 and sheets Nos. 1, 2 and 3 from May, 1943, to and including October 14, 1947, may be received in evidence as petitioner's Exhibit 14.

21. Cancelled checks of Trepte Construction Company of date, number, payee and account as follows are the paid vouchers for expenditures in Account No. 294, Exhibit 14:

Date	Number	Payee	Amount
3/15/43	6132	U. S. Collector of Int. Rev.....	\$3,103.30
4/ 8/43	14	California State Treasurer	329.04
5/ 3/43	121	Albert E. Trepte	750.00
6/12/43	307	Collector of Internal Revenue....	3,103.30
9/16/43	699	Albert E. Trepte	6,554.74
9/13/43	681	Collector of Internal Revenue....	3,103.31
8/12/43	548	California State Treasurer	329.04
12/21/43	1043	Albert E. Trepte	5,000.00
12/10/43	1022	Franchise State Commissioner....	329.03
12/10/43	1018	U. S. Collector of Int. Rev.....	3,103.30
6/12/44	1814	Collector of U. S. Int. Rev.....	1,420.00
4/11/44	1514	Collector of U. S. Int. Rev.....	710.00
4/11/44	1511	State Treasurer	346.76
3/13/44	1376	Collector of U. S. Int. Rev.....	2,247.29
7/21/44	1985	Albert E. Trepte	5,302.38
9/ 3/44	1-B	Marshall Fridley	35.00
8/ 9/44	1-A	Marshall Fridley	35.00
9/27/44	1-C	Walter E. Smith	425.00
9/ 8/44	2709	Collector of U. S. Int. Rev.....	925.00
10/12/44	1-D	Marshall Fridley	35.00
11/ 3/44	3046	Julius Sturz	76.88
11/10/44	1-E	Marshall Fridley	35.00
12/10/44	1-F	Marshall Fridley	35.00
12/26/44	2455	Albert Eugene Trepte	5,227.40
3/10/45	3647	Franchise Tax Commissioner.....	55.65
9/ 4/45	4759	Collector of U. S. Int. Rev.....	52.23
12/28/45	5456	Albert Eugene Trepte	10,463.27
1/11/46	5590	Collector of U. S. Int. Rev.....	11,150.00
3/29/46	6059	Franchise Tax Commissioner.....	428.77
4/ 3/46	6077	SEA—The Pac. Yachting Mag...	2.05

Date	Number	Payee	Amount
6/10/46	6626	Collector of U. S. Int. Rev.....	610.97
7/ 9/46	6748	The Coronado	97.38
5/16/46	6451	California Polytechnic School.....	10.00
9/ 7/46	7223	Eugene Trepte	500.00
9/11/46	7284	Collector of U. S. Int. Rev.....	1,325.00
12/31/46	7990	Collector of U. S. Int. Rev.....	7,025.00
1/27/47	8157	Treas. of U. S. c/o Vet. Admin.....	6.40
2/18/47	8344	Treasurer of the U. S.....	6.40
3/11/47	8526	Collector of U. S. Int. Rev.....	300.55
3/27/47	8572	Franchise Tax Commissioner.....	417.13
3/28/47	8580	Treasurer of the U. S.....	6.40
4/25/47	8762	Treasurer of the U. S.....	6.40
6/ 2/47	8970	Treasurer of the U. S.....	6.40
6/ 6/47	9034	Collector of U. S. Int. Rev.....	2,250.00
7/18/47	9326	Treasurer of the U. S.....	6.40
8/15/47	9490	Treasurer of the U. S.....	6.40
9/ 2/47	9517	Collector of U. S. Int. Rev.....	2,250.00
9/ 3/47	9522	Eugene Trepte	150.00
9/ 3/47	9524	Eugene Trepte	600.00

22. Photostatic copies of ledger sheets of Account No. 283 captioned "Walter B. Trepte Capital" on the books of account of Trepte Construction Company, being 2 sheets for 1943 and 1943 through 1946 may be received in evidence as petitioner's Exhibit 15.

23. Photostatic copies of ledger sheets of Account No. 284 captioned "Albert Eugene Trepte Capital" on the books of account of Trepte Construction Company, being 2 sheets, 1 for 1943 and 1 for 1943 through 1946, may be received in evidence as petitioner's Exhibit 16.

24. A 1942 income tax return was filed by Walter Trepte with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 17-C.

25. A 1943 income tax return was filed by Walter Trepte with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 18-D.

26. A 1942 income tax return was filed by Margaret Trepte with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 19-E. [75]

27. A 1943 income tax return was filed by Margaret Trepte with the Collector of the Sixth District of California, which return may be received in evidence as Joint Exhibit 20-F.

28. Attached hereto is certified copy of document entitled "Certificate of Partnership of Fictitious Name" of Trepte Construction Company, dated May 11, 1942, which may be received in evidence as petitioner's Exhibit 21.

29. Either party to this proceeding may withdraw any of the Exhibits referred to in this Stipulation by substituting a true photostatic copy thereof.

Dated: November 24, 1947.

/s/ GEORGE H. STONE,
Counsel for Petitioner.

/s/ WM. D. MORRISON,
Counsel for Petitioner.

/s/ CHARLES OLIPHANT, E.C.C.,
Chief Counsel,
Bureau of Internal Revenue,
Counsel, for Respondent.

J.H.P. 11/29/47; B.H.N., E.C.C., 11/29/47; C.O., E.C.C., 11/29/47.

[Endorsed]: T.C.U.S. Filed Dec. 1, 1947. [76]

Official Report of Proceedings Before
The Tax Court of the United States

Docket Nos. 12515, 12516

WALTER TREPTE and MARGARET TREPTE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

EXCERPTS FROM THE TRANSCRIPT OF
TESTIMONY

Hearing at Los Angeles, California

Date: December 1 and 2, 1947

Before: Honorable Richard L. Disney, Judge.

Appearances: George H. Stone, 1004 San Diego Trust and Savings Building, San Diego 1, California, and William D. Morrison, 625 Bank of America Building, San Diego, California, appearing for the Petitioners. John H. Pigg, (Honorable Charles Oliphant, Chief Counsel, Bureau of Internal Revenue), appearing for the Respondent. [154]

WALTER B. TREPTE

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name?

The Witness: Walter B. Trepte.

The Court: Now, Mr. Clerk, I don't think we

made it sufficiently plain to these witnesses and they might not understand. Go out and inform them that they are not to remain within earshot of the testimony and not to listen to the testimony.

The Clerk: Yes, your Honor.

Direct Examination

By Mr. Stone:

Q. You are the son of Walter Trepte and Margaret Trepte? [78] A. That is right.

Q. The Petitioners in this case? A. Right.

Q. You are 29 years of age? A. Right.

Q. Live in San Diego? A. Right.

Q. How long have you lived there?

A. 29 years.

Q. What schooling do you have?

A. Grammar school, high school and half a year of college.

Q. What college? A. Cal. State.

Q. Did you ever work for your father in his construction business prior to January 1st, 1942?

A. Yes.

Q. When did you first work for him?

A. The summer of 1935.

Q. Did you work in 1936?

A. Worked in 1936.

Q. For how much of the year?

A. Summer, two months.

Q. In 1937, what did you work?

A. I didn't work at all in 1937. [79]

Q. In 1938?

A. I worked in the fall of 1938.

(Testimony of Walter B. Trepte.)

Q. Did you work at all in 1939?

A. All of 1939.

Q. During those times what were you doing, all the times I mentioned.

A. In 1935 I was a truck driver, and in 1936 just on the truck driving, and 1938 I worked in the office as assistant to the bookkeeper, and timekeeper, and various duties around the office that are rather hard to classify.

Q. Did you work in 1940?

A. In 1940, from July on.

Q. Where did you work?

A. July and August, or July, I went to work for Walter Trepte. From August on to the end of the year for Golden and Trepte.

Q. Where? A. At North Island.

Q. What were you doing?

A. I was in the timekeeping office.

Q. Did that occupation keep up the rest of 1940?

A. That completed 1940.

Q. 1941 where did you work?

A. January through May or June I continued to work at the Naval Air Station, timekeeping office, and then from [80] July on to the end of the year I worked for Golden & Trepte Construction Company at the naval fuel depot.

Q. The naval fuel depot is in San Diego?

A. That is right.

Q. And the naval air station where you were working is in San Diego Harbor?

A. That is San Diego, yes.

(Testimony of Walter B. Trepte.)

Q. What work were you doing at the naval air station and at the fuel depot?

A. At the naval air station for the full time I was there I was in the timekeeping office. At the fuel depot I was in charge of personnel and time-keeping, did some of the bookkeeping, took care of certain security work that the navy requested.

Q. In that position did you do any hiring and firing of the men? A. All of it.

Q. Was it all office work?

A. Practically all, yes.

Q. You entered into this partnership agreement which has been referred to here, dated January 1, 1942, did you? A. Yes.

Q. Was that talked over between you, your father and mother before it was made?

A. Fully discussed, yes. [81]

Q. Do you have any physical disability that prevents you from doing outside hard physical labor?

A. No, none that I know of.

Q. You did have at one time.

A. Yes, at one time I did have.

Q. Entirely free of it? A. Yes.

Q. The discussion of the making of the partnership agreement, if you can remember, what was the first brought out, at what time?

A. As I remember, it was in the fall of 1941.

Q. Was the immediate cause or purpose of that discussion mentioned by your father at that time?

A. It was generally spoken of as a possibility of so many trips by plane to San Clemente Island.

(Testimony of Walter B. Trepte.)

To land at San Clemente Island was very treacherous, there are certain dangers to a plane, so he felt that at the time some of the operation of the company should be put into other hands besides his own.

Q. That operation at San Clemente Island was under whose jurisdiction?

A. It was in conjunction with the Golden & Trepte Construction Company.

Q. Did your father take trips to the island?

A. Quite often. [82]

Q. By what means?

A. Airplane altogether.

Q. Do you know how far that is from the coast?

A. Oh, I would say about 100 miles.

Q. You have never been there?

A. Yes, I was there once.

Q. What compensation did you draw during that time from 1935 through 1941?

A. Well, just pay. I was on the payroll as an employee.

Q. At what rate?

A. Well, it went up as time went along. It started out at about \$15 a week, went up to around \$20, \$22.50, up to \$25 and \$30. As I remember when I worked for Golden & Trepte it stopped at around \$35.

Q. Since the formation of the partnership, January 1, 1942, where have you worked?

A. Let's see. The first three months of 1943 and four months of 1942 I worked for Golden & Trepte finishing up this naval fuel depot contract that was

(Testimony of Walter B. Trepte.)

in process of being completed. And then toward the end of that, which was about June or July, I went to work for the Golden Trepte Company at the Rohr Aircraft Corporation and then in about October or November I went to the Golden Trepte Construction Company at the naval air station on North Island, and I [83] stayed there until the completion of the contract in approximately October or November of 1943, and then from then on until about, I believe about the middle of 1944 I worked again at the Rohr Aircraft Corporation for the Trepte Construction Company, and then following that except for a brief period of about four months on the navy contract at the naval air station I worked on the Trepte Construction Company work.

Q. How were you paid during that period from January 1st, 1942 on?

A. Paid a regular salary.

Q. From Trepte Construction Company?

A. From Trepte Construction Company, yes.

Q. Did you also receive payment on the payrolls of the company on the other jobs.

A. Yes. At the second Rohr job, it was a DPC contract, I received extra remuneration.

Q. What was done with the extra remuneration?

A. That was payed back into the partnership.

Q. Into the Trepte Construction Company?

A. That is right.

Q. How much per week were you receiving

(Testimony of Walter B. Trepte.)

from the Trepte Construction Company from 1942 to 1946? A. Fifty-five dollars.

Q. Fifty-five dollars a week? [64]

A. Yes.

Q. During that period from 1942 to the present, you had no other remuneration, did you?

A. Just that that was received from Rohr.

Q. Any adjustment of salaries in the partnership?

A. Yes, there was an adjustment at the end of each year up to a sum of around forty-eight hundred dollars.

Q. You mean adjusting that fifty-five dollars a week up to the amount of forty-eight hundred dollars a year? A. That is right, yes.

Q. For what years was that done?

A. 1943, 1944, I believe 1945, 1946.

Q. At that time was there any adjustment of your father's drawing?

A. I believe there was, but I can't remember the exact figure.

Q. In the last two years, what have been your duties for Trepte Construction Co.?

A. Well, to generalize I would say office manager.

Q. Are you hiring and firing people?

A. Yes.

Q. Do you ever sign checks? A. Yes.

Q. Under the partnership agreement, you have a twenty-four percent interest in the partnership profits. Do you use any of those proceeds for your

(Testimony of Walter B. Trepte.)

own personal use? A. No.

Q. Some of them were withdrawn, shown in the exhibit [85] here, in payment of your note?

A. Yes, that is right.

Q. Under Exhibit 13 it shows Walter B. Trepte authorized on March 20, 1942, the distribution of an item to the Red Cross fund, \$5.00. Was that yours?

A. Yes, that was mine. I will have to amend my answer, in that there were various small withdrawals that I made during the first two years.

Q. And on May 9, 1947, there is a further amount shown of \$10.30. Was that for your personal use? A. I imagine it was.

Q. Are you familiar with the books of the Trepte Construction Co.?

A. Quite familiar, yes.

Q. Do you know what this Account Number 293, Walter B. Trepte Drawing, is?

A. That was an original account of withdrawals, as I remember. It is not in use.

Q. Do you know what is credited to it?

A. I believe in the beginning that my salary was, but I am not—I am a little hazy on that.

Q. Your check, wasn't it?

A. That was my check.

Q. What else was credited to that?

A. I believe—let's see—my payments on notes, those I remember too.

Q. December 8, 1942, typewriter, typewriter desk and posture chair, \$97.63. February 8, 1944,

(Testimony of Walter B. Trepte.)

record album, [86] Thearle Music Co., \$32.40. Is that yours? A. That is mine.

Q. And December 26, 1945, J. W. Campbell, 1,000 common brick, \$20.00. Is that yours?

A. Yes.

Q. Under date of March 23, a radio transiever for \$80.46. A. That is personal.

Q. June 24, 1946, Railway Express Agency, pickup from gramophone shop, \$20.37.

A. That is mine.

Q. July 15, Plaza Hotel, San Francisco, check for \$100.00. Is that yours?

A. That is mine, yes.

Q. July 18 package from gramophone company, \$18.74. A. That is right.

Q. Ditto for \$35.00. A. That is right.

Q. August 23, Concord Radio Corporation, merchandise, \$13.85. A. That is mine.

Q. There are items like this one here, April 15, 1943, first quarter income tax. Was that for your individual income tax? A. Yes.

Q. April 7, first third state income tax, was that for your individual income tax? A. Yes. [87]

Q. You referred to the adjustment of partners' salaries. There is an item on December 30, 1944, which shows partners' salaries, adjusting 1944 salary, to \$4800.00 from \$2605.00, \$2195.00.

A. That is one, yes.

Q. The same thing was done in subsequent years? A. That is right.

Q. Is it a fact that on a great many or most

(Testimony of Walter B. Trepte.)

of the items charged against you, you either drew the checks or signed them? A. I did.

Q. On the Trepte Construction Co. account?

A. That is right.

Q. And they were charged to you on your withdrawal account? A. That is right.

Mr. Pigg: Let him testify, please.

The Court: Don't lead your witness.

By Mr. Stone:

Q. Has your interest in the partnership the sum of twenty-nine thousand, nine hundred and some dollars on your original purchase increased?

A. Yes, it has.

Mr. Pigg: I will object on the ground that calls for a conclusion, your Honor.

The Court: The objection is overruled. Now, unless it is made more particularly it would not be worth very much, but the objection is overruled. [88]

By Mr. Stone:

Q. I show you Exhibit No. 15, headed Walter B. Trepte, Capital, and refer you to the first item, March 31, 1943, transfer of capital from Walter Trepte, \$28,941.17, and on the next page, the second item, September 18, 1943, adjust error in previous entry recording share purchased from Walter Trepte \$1,000.00. What do those two items represent?

A. They represent my original ownership or original share in the partnership.

Q. And on March 31, 1943, appears "P. L. 1942". What does that refer to?

(Testimony of Walter B. Trepte.)

A. Profit and loss.

Q. \$29,665.07. What does that represent?

A. That was representative of about the same thing, as I understand it.

Q. Your share of the profits for that year?

A. Yes.

The Court: Don't lead your witness.

By Mr. Stone:

Q. In 1944, February 16, Thursday item, "Closing 1943 entries, \$23,664.00". Do you know what that item represents?

A. That was, I believe, profits for that year.

Q. And December 30, 1944, "Profit and Loss, 1944 distribution, \$8,336.56."

A. That is profit and loss for that year, my share of it. [89]

Q. And on December 31, 1945, "Profit and Loss, 1945 distribution, \$25,389.29."

A. That was my share of it.

Q. Again December 31, 1946, "Profit and Loss, 1946 distribution, \$25,067.35."

A. That was my profit for that year.

Q. In the right hand column, headed Balance, the amount of \$62,506.03, what does that represent?

A. That represents my total share of the partnership as set at that time.

Q. I show you Exhibit 11, which is called Employee S. S. Account for Walter B. Trepte. On the last page of his record of 1942, was one column \$40, 40 cents in two other columns.

(Testimony of Walter B. Trepte.)

A. Those represent social security and unemployment tax.

Q. Where were you working at that time, from January 1942 through June 20, 1942?

A. At the Naval Fuel Depot.

Q. Were those deductions paid to the government?

A. I don't believe they were. I believe they found it was an error.

Q. When you were working, you said for the Golden & Trepte Construction Co. and Rohr, were there deductions as—of social security?

A. I believe there was for a portion of a couple of [90] weeks, then it was stopped.

Q. And what was the salary that you said you turned in to the Trepte Construction Co. for Rohr, was it the net amount or the gross?

A. I believe it was the—I believe the net amount.

Q. At the time you spoke of having the first discussion with your father of the formation of the partnership, was the question of tax reduction or avoidance brought up? A. No.

Q. Was it at any time during the discussions regarding the formation of the partnership and the purpose of it?

A. No, it never was mentioned.

Mr. Stone: You may cross examine.

Cross Examination

By Mr. Pigg:

Q. Mr. Trepte, what did you say the degree of

(Testimony of Walter B. Trepte.)

your familiarity is with the books and records of the Trepte Construction Co.?

A. I have a fairly good——

Q. Do you keep or make any of the records in those books?

A. No, I have not made any entries except within the last year, certain phases of the books.

Q. When did you first see or examine the records as to which you have just testified here under direct examination? [91]

A. Each year I have seen them.

Q. What was the extent of your examination of all those accounts each year, and for what purpose was the examination made?

A. For my own information, a rather cursory examination.

Q. Are you a bookkeeper?

A. I wouldn't call myself a full accountant.

Q. Do you understand the difference between debts and credits? A. Well, certainly.

Q. The theory of accounting?

A. Beg pardon, didn't get that?

Q. The theory of accounting?

A. A good percentage of it. I wouldn't say I was really polished in it.

Q. When did you examine these accounts for the purpose of giving your testimony at this trial?

A. Of course I have seen them practically every day for the last year or so, putting in the entries in the particular books that I work upon.

Q. Mr. Trepte, here is Petitioner's Exhibit No.

(Testimony of Walter B. Trepte.)

9 which is the note that has been stipulated that you signed in connection with the transaction in which the alleged partnership agreement was executed on January 1, 1942. A. Yes. [92]

Q. You recognize that note, do you not?

A. I do. I signed it.

Q. This is your signature?

A. That is right.

Q. It bears the endorsement on the face of it "Cancelled December 29, 1945."

A. That is when the last payment was made, at that time.

Q. It is true, is it not, that each of the payments you have described them, were made from the profits of the business of the Trepte Construction Co.?

A. Yes.

Q. Mr. Trepte, assuming that the stipulation of facts in this case shows that the amount of \$6554.74 is charged to your withdrawal account on September 16, 1943, it is a fact, is it not, that that amount was withdrawn for the purpose of making the payment on the note? A. Yes, I believe it was.

Q. And isn't the same thing true as to the item of five thousand dollars charged to your account on December 21, 1943, assuming there was such an item charged to your account on that date?

A. I believe partially, yes.

Q. Isn't the same thing true as to an amount of \$5302.38, if such an amount was so charged in the account on July 21, 1944? [93]

A. Part of it, yes.

(Testimony of Walter B. Trepte.)

Q. And isn't the same thing true as to the amount of \$5500.00 assuming that such an amount was charged to the same account on December 31, 1944? A. Yes, I believe so.

Q. Isn't the same thing true as to the amount of \$10,500.00, assuming that the amount is charged to the same account on December 28, 1945?

A. Yes.

Q. Assuming that these five items equal or aggregate \$32,857.12, which amount exceeds the face of this note, which is \$29,947.17, by the amount of approximately \$2910.00, you notice it is more than the whole amount as contemplated by the face of the note. A. Yes.

Q. Mr. Trepte, that purports to be your income tax return for the year 1942. Is it or is it not?

A. It is.

Q. Is that your signature? A. Yes, sir.

Q. Page number one? A. That is right.

Q. Does the income as reported on the return represent that portion of the income of the Trepte Construction Co. for that year? [94]

A. Yes, sir.

Q. Is there any income from any other source reported in the return?

A. I believe one small—

Q. For instance, what is it? To save time, I will call your attention to \$29,529.06. What does that represent, do you know?

A. That is my amount of my share at that time.

Q. Do you know what this item of \$1895.85 represents?

(Testimony of Walter B. Trepte.)

A. That is what I received from Golden & Trepte.

Q. Golden & Trepte? A. That is right.

Q. Construction Co.? A. That is right.

Q. And now, isn't the amount of tax shown as due on your 1942 return the amount of \$14,036.58?

A. It is.

Mr. Pigg: I ask that this be marked for identification as Respondent's Exhibit G. I believe, your Honor, I should perhaps offer this later, instead of offering it at this time in the Petitioner's case.

The Court: Do as you please, they are a part of your case.

Mr. Pigg: I will offer that return at this time, to save time, as Respondent's Exhibit G. [95]

The Court: Respondent's Exhibit G is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit G.)

By Mr. Pigg:

Q. Mr. Trepte, assuming that the stipulation of facts, and I refer particularly to paragraph 19, the stipulation of facts shows that the following amounts on the following dates were charged to the Withdrawal Account, namely on March 15, 1943, \$3509.15, June 12, 1943, \$3509.15, September 1943, \$3509.14, December 10, 1943, \$3509.15 and assuming that those four amounts equal or aggregate \$14,036.59, would you say it is or is not a fact that the

(Testimony of Walter B. Trepte.)

checks were issued to pay your income tax on your return for 1942? A. They were.

Q. Is that your income tax return for the year 1943? A. Yes, sir.

Q. Is it your signature on the face of it?

A. That is right.

Q. There is an item of \$25,523.78 reported as income on your return.

A. That is right. That is my share of profit for that year.

Q. Of the Trepte Construction Co.?

A. That is right.

Q. That shows on line 20 unpaid balance of 1943 income [96] and victory tax, the amount of \$2,602.24, does it not? A. It does.

Mr. Pigg: I offer this return in evidence as Respondent's Exhibit H. Any objection?

Mr. Stone: No. May I see it a minute?

The Court: Respondent's Exhibit H is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit H.)

By Mr. Pigg:

Q. Mr. Trepte, assuming that the stipulation of facts shows the amount of \$2602.34 was similarly charged to your Withdrawal Account on or about March 13, 1944, would you say that it is or is not a fact that the amount represented a check drawn to pay the tax shown on your 1943 return?

A. I believe it was.

(Testimony of Walter B. Trepte.)

Q. Were you in military service at any time during that year? A. No, I was not.

Q. Mr. Trepte, there are a number of other items—I am trying to save time—shown in the stipulation of facts paragraph 19, as checks issued to the collector of internal revenue. Is it or is it not a fact that the money, that in each such instance of such payment the item represents checks drawn against the funds of the Trepte Construction Co. to pay [97] the tax reported on your income tax return for that year? A. Yes, it would.

Q. And now would that be true also, Mr. Trepte, as to state income or other taxes in the case of any such items charged to your Withdrawal Account and labeled as checks to the California State Treasurer or franchise tax commissioner. A. Yes.

Q. That means that we are to understand those payments have been made on account of income reflected in the returns of the Trepte Construction Co.? A. Yes, they would.

Q. One question. When the execution of the agreement as of January 1, 1942, was discussed, I believe you said that was in the fall of 1941?

A. Yes, it was.

Q. Where did that first discussion take place?

A. It was at home and in our office.

Q. Who was present when it was discussed at home?

A. My father and my mother and myself, my brother Gene and myself.

(Testimony of Walter B. Trepte.)

Q. Who was present when it was first discussed at the office?

A. My father, my brother Gene and myself.

Q. And now, it is fair to assume, is it not, that it [98] was discussed on numerous other occasions prior to the time it was finally signed?

A. Oh, yes, in past years.

Q. Did all those discussions likewise take place either at your residence or at the office?

A. That is right.

Q. And is it likewise true that there were present at each discussion only the persons we have already mentioned?

A. As far as my memory serves me, that is correct.

Q. Do you know a Mr. Essenhoff?

A. Essenhoff?

Q. The name Carl N. Essenhoff?

A. That is right.

Q. What is his business or occupation, if you know?

A. He is a certified public accountant.

Q. Do you know whether he has ever done any work for the Trepte Construction Co.?

A. Yes, he has.

Q. Did he do that work before January, 1942?

A. I believe he did.

Q. And some since?

A. Some since, every year.

Q. Are you sure that Mr. Essenhoff was not present at these discussions, or any of them?

(Testimony of Walter B. Trepte.)

A. Not to my memory, not as far as I can remember. [99]

Q. You are not prepared to testify he was not?

A. No, I would say he was not.

Q. You are sure he was not?

A. He was not, no.

Q. Not at any one of them.

A. Not at any of them, no.

Q. Did you personally discuss the matter with him at any time? A. No, I never have.

Q. Do you know whether your father did?

A. I couldn't say.

Q. Do you know whether your mother did?

A. I couldn't say that either.

Q. Do you know whether your younger brother did? A. I couldn't say that.

Q. You are the older brother, are you not?

A. That is right.

Q. I believe you said that you had worked for the Trepte Construction Co. at least on various occasions or periods since sometime in 1935?

A. That is right.

Q. The Trepte Construction Co. in 1935 was the business of your father, Walter B. Trepte, was it?

A. Walter Trepte.

Q. I mean Walter Trepte, the same business that has [100] been carried on since that time down to the present date, is it not?

A. That is right.

Q. Prior to 1941, what generally, if you know,

(Testimony of Walter B. Trepte.)

was the major or type of construction work performed by the Trepte Construction Co.?

Mr. Stone: May I interrupt there? I think that is a misstatement, because it was not the Trepte Construction Co. until after January 1, 1942. It might confuse the facts.

Mr. Pigg: I will take that. I don't want any misunderstanding.

By Mr. Pigg:

Q. Under what name was the business of your father carried on prior to January 1, 1942?

A. Walter Trepte Builder.

Q. What did he build prior to the year 1941, for the most part?

A. All types of construction, but particularly types of a commercial nature, such as store buildings, garages, work of that type, some warehouses.

Q. It was either all or mostly on contract construction? A. Yes, it was.

Q. And it necessitated a person having knowledge of construction engineering and prices, markets, and materials? A. Yes. [101]

Q. Knowledge of those and simliar matters was necessary in order to qualify a person to submit or make a bid for a job of that kind, isn't that right?

A. Yes, sure.

Q. But who prior to 1941, as far as Walter B. Trepte Builder was concerned, was possessed of that knowledge or qualification?

A. We had my father, and then in past years we have had other estimators in there.

(Testimony of Walter B. Trepte.)

Q. Other estimators you mean employed?

A. That is right.

Q. As an employee? A. That is right.

Q. But as far as any bid figure or estimate that was made and prepared by any such employee, it was ultimately determined by your father whether it was the proper bid that would be submitted as an offer or as a bid for the construction job?

A. Yes, it would have been examined by him.

Q. I assume that since 1941 the same has been true?

A. In some cases. Many things I look at them first, the smaller type of jobs.

Q. The smaller type of jobs? A. Yes.

Q. Beginning in 1941, is it not a fact, that all or [102] practically all the construction work performed by Walter Trepte Builder was on government contract? A. Yes.

Q. Beginning in 1940 or 1941?

A. Yes, yes. It—

Q. How long prior to January 1, 1942, were you familiar with the business known as the Golden & Trepte Construction Co.?

A. I was employed by that company in the month of its inception and I worked clear through I think I believe it was to 1943 when we finally wound up the large contract for the navy station at North Island.

Q. Do you know whether it was in the year 1940 that your father and Mr. M. H. Golden associated themselves in business known as the Golden

(Testimony of Walter B. Trepte.)

& Trepte Construction Co.? A. They did.

Q. And it was that year?

A. That is right.

Q. What type of construction work was your father engaged in at that time in 1940?

A. Mostly work for the U. S. Navy.

Q. Was that the contract or the job that is identified in the contract of January, the agreement of January 1, 1942, as the naval air station job equity, do you know?

A. That was the contract, NOY-4205. [103]

Q. That was a government contract?

A. That is right, the Navy.

Q. And that contract was obtained really in 1940? A. In 1940, in the summer of 1940.

Q. Golden and your father associated themselves primarily for the purpose of undertaking that contract, did they not?

A. I believe that, and several others.

Q. Do you know whether there is in the courtroom today the originals of those government contracts? A. Copies only.

Q. Copies only? A. Copies of the original.

Q. And now, Mr. Trepte, I hand you Petitioner's Exhibit No. 4. A. Yes.

Q. That is described as the deficiency notice mailed to your father, Walter Trepte.

A. Yes.

Q. I call your attention to page 2 of the statement which is attached to the letter. A. Yes.

Q. And to an item described as salary paid to

(Testimony of Walter B. Trepte.)

Walter B. Trepte, \$495.00. A. Yes. [104]

Q. Then on page 5 of the same statement in the same exhibit, I call your attention to an item described as salary paid to Walter B. Trepte, \$2530.00.

A. Yes.

Q. Are you the Walter B. Trepte?

A. I am.

Q. These adjustments of salary that you referred to as having been made at the end of one or more years, I believe including 1944—at any rate, it is correct, is it not, to assume that those salary adjustments were made entirely in accordance with the plan as contemplated by this agreement of January 1, 1942? A. Yes, they were.

Q. And the amounts were fixed and determined as provided in that agreement? A. Yes.

Q. Mr. Trepte, I will hand you Exhibit 15, which I think is the same exhibit you were examining a while ago, at least concerning which the counsel for the Petitioner was questioning you.

A. Yes.

Q. And that is captioned Walter B. Trepte, Capital. A. Yes.

Q. You recognize that? A. I do. [105]

Q. And the first item below is \$28,921.47. It is fair, is it not, to assume that that is the item which is associated with the note for \$27,000.00 which is in evidence? A. Yes, it is.

Q. There is an error of \$1,000.00, is there not?

A. I believe there is.

Q. It is \$28,000.00. Is there another entry that

(Testimony of Walter B. Trepte.)

corrects that error later on? A. Later on.

Q. At the time that corrected entry was made to this account, Exhibit 15, do you know what if any entry was made in the Capital account of your father, Walter Trepte?

A. I believe there was a debit made.

Q. A corresponding debit? A. Yes.

Q. As to the various and sundry small items, including the Red Cross contributions, these small radio items and items that you had purchased, they were items you had purchased and the amount paid was paid by the Trepte Construction Co. and charged to your account?

A. Yes, that is what they are, yes.

Q. Now, were those items checked off, I mean set off or offset against your salary of \$55.00 a week or thereabouts? A. Would you repeat that?

Q. Were those items set off or balance or offset against your salary that you were drawing?

A. No, they would be against my capital.

Q. Charged to your Withdrawal Account?

A. That is right.

Q. To your capital account and not against your compensation? A. Yes.

Mr. Pigg: I think that is all, your Honor.

The Court: Any further direct examination?

Redirect Examination

By Mr. Stone:

Q. Mr. Trepte, did you hear the partnership agreement read in court this afternoon?

A. I did.

(Testimony of Walter B. Trepte.)

Q. You had read it before you had signed it, had you not? A. Oh, yes.

Q. We have referred to the fact of the division of the profits on the basis of 26-26-34-24 percent. Do you know of your liability, if the company have losses, how that would be?

A. I believe I would have the same liability.

Q. You were asked if you were in the military service and answered it no. Why were you not?

A. I was 4-F. [107]

Q. For what reason? A. For eye trouble.

Q. He read a few items from this account of Walter B. Trepte withdrawals. The counsel was referring to a few and there were a great many others, were there not, that were charged to you out of this Withdrawal Account for your own expenditures? A. Yes.

Q. Are these that we have listed in our stipulation in paragraph 19, Clarion Sound Engineering Co., \$97.50, is that one of those?

A. That is mine.

Q. D. G. King, \$161.75?

A. That was one of mine.

Q. What was that for?

A. That is radio parts.

Q. Thearle Music Co., \$577.31. Was that yours?

A. That was mine, yes.

Q. For your personal radio?

A. I think so, yes.

Q. And New York Life Insurance Co., \$391.40?

A. That is my personal policy, yes.

(Testimony of Walter B. Trepte.)

Q. And Precision Radio, \$144.15?

A. That was some of my personal.

Q. L. E. Behymer, \$50.00? [108]

A. That is mine.

Q. The Music Den, \$92.70?

A. That is right.

Mr. Stone: That is all of this witness.

The Court: We will take a recess at this time of ten minutes.

(Short recess taken.)

The Court: Proceed with the trial.

Mr. Pigg: Your Honor, there are two or three other questions I would like to ask the witness. I believe you had finished on your redirect.

Mr. Stone: I had finished, yes, sir.

Recross Examination

By Mr. Pigg:

Q. Mr. Trepte, I believe you said that you signed checks. A. Yes.

Q. Against the partnership account?

A. Yes.

Q. The bank account. Who authorized you to sign those checks?

A. Well, we authorized ourselves by the partnership agreement. One section of it says that the partners shall have the right to. I will go further, saying that the account before it became the Trepte Construction Co. was in [109] the name of Walter Trepte before it was changed to the Trepte Construction Co. Then I was authorized to sign for Trepte Construction Co., and you understand that

(Testimony of Walter B. Trepte.)

I signed checks for Walter Trepte as far back as about I would say 1937, on the general account, and then later on for simplicity we divided it up into a general and payroll account, and I signed both of them.

Q. In other words, you were authorized by your father to sign checks against his business account before as well as after January 1, 1942?

A. That is right, yes.

Q. And after 1942, you were authorized in the manner as described in the agreement of January 1, 1942?

A. That is right, yes.

Q. As to the employees that you hired and fired, I believe you said you did?

A. Yes.

Q. When did you hire the first employee?

A. Well, that is rather hard for me to state, because I did on occasion hire them back in the days when I was working for my father as Walter Trepte, Builder.

Q. Was that true also as to the Golden & Trepte Construction Co. when you worked for them?

A. I didn't hire there until about when I started on the fuel depot in about May of 1941, I hired there. In fact [110] I did all of the clerical work that was done on that job.

Q. Now, assuming that the agreement of January 1, 1942, is silent so far as who was authorized to hire and fire employees, on whose authority did you hire and fire employees?

A. My father's, and then of course with the

(Testimony of Walter B. Trepte.)

Golden-Trepte, both my father and Mr. M. H. Golden.

Q. And before you hired and fired any such employee, would you discuss it with your father?

A. Not always. Certain run of the mill employees, that were on an hourly or day to day basis I just hired and fired as the need for them.

Q. As the business of the department?

A. That is right.

Q. In other words, when you had taken on a new contract, a new job, you kept a certain number of representative employees and hired the laborers and the rest of the jobs? A. That is right.

Q. And you did some of the hiring and firing under those circumstances?

A. I did practically all of it.

Q. And the same before as well as after January 1, 1942? A. That is right, yes.

Mr. Pigg: That is all.

Mr. Stone: That is all. If the court please, could [111] counsel excuse this witness from further attendance at court?

Mr. Pigg: As far as I know now.

Mr. Stone: All of them have to go home, and I want to get two more excused by the end of the day.

Mr. Pigg: I can say I know of no reason at the moment why you should recall him.

The Court: Of course, it is rather dangerous to leave it indefinite, if you might want him here. If you want him here we can't wait while you go and get him, once you definitely excuse him.

Mr. Pigg: That is agreeable to me, your Honor. I don't know any reason why.

The Court: Very well. This witness is excused from further attendance.

(Witness excused.)

Mr. Stone: I will call Eugene Trepte.

Whereupon,

ALBERT EUGENE TREPTE

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: Tell us your name, please.

The Witness: Albert Eugene Trepte. [112]

Direct Examination

By Mr. Stone:

Q. How old are you? A. 22.

Q. When did you become 21?

A. September 8, 1946.

Q. Have you ever worked for your father in his construction business? A. Yes, I have.

Q. When?

A. In 1941 I worked out at the fuel depot and in 1942 I worked—these are the summers I worked—at Ryan's new addition of the new building. In 1943 I went to summer school and I didn't work that year on account of being drafted. The next years I was in the Navy. In 1946 I was out of the service and about a month there I didn't do anything after getting out of the service, and then I worked down there in a capacity of rustling ma-

(Testimony of Albert Eugene Trepte.)

terial. This year, 1947, I worked in the office taking care of bills.

Q. How long were you in the service?

A. From January 28—no, February 28, 1944, until June 7, 1946.

Q. Where did you serve?

A. I served in the Navy aboard—I was connected with the western sea frontier, southern sector. I was aboard a [113] patrol ship operated out of southern frontier base, San Diego.

Q. Where did you patrol?

A. We patrolled the Guadalupe patrol, which is about 600 miles off San Diego. We patrolled the sea patrol a month at a time.

Q. What kind of vessel was it?

A. It was a 205 foot schooner that was sail that was one of the ships that was turned over to the government for this Pacific patrol.

Q. What were your main duties on that ship?

A. Well, I held the rate when I first went aboard of a First Seaman, first, and then as the war pressure came on we lost officers who had experience in sailing and I was put in the capacity of Leading Seaman of handling sails and handling the docking of the ship. When I was schooled for this job I went into the quartermaster department.

Q. And as Sailing Master you directed the men, did you?

A. Yes, even directed officers for a while.

Q. This work in 1941 at the fuel depot, how much were you paid?

(Testimony of Albert Eugene Trepte.)

A. I believe it was about 75 cents an hour.

Q. What kind of work were you doing?

A. I was crew for awhile on a duck, and then I was also working with the piledriver. [114]

Q. In 1942 at the Ryan building, what kind of work were you doing?

A. I was working as assistant carpenter, assistant.

Q. What were you paid then?

A. I believe it was about 85 cents an hour.

Q. Have you done any work for the partnership since January 1st, 1942, without wages?

A. Yes, I have.

Q. What and where?

A. In 1943, when the partnership was formed I was working in the delivery of material and rustling of material. That gave me a chance to get around the jobs and understand what was going on and what jobs we did have on, being completed and under construction, and also I would go with my father to look at different jobs that we were estimating.

Q. Discuss them with him? A. Yes.

Q. In the work in 1946 on material and 1947 in the office, were you paid anything for that?

A. No, sir, I wasn't.

Q. What schooling have you had?

A. Well, after I was released from the service—before I was, while I was away, my father and I talked it over one time when I had a leave, about where I wanted to go, and I wanted to go into the

(Testimony of Albert Eugene Trepte.)

business. We were looking for a [115] school that I could get through in not too much time, so I could get into business instead of going through so much technical basis, that I wanted to learn more of the practical end of it, so he inquired around and found a school, what they call the California State Polytechnic College at San Luis Obispo, where I am now enrolled in my second year.

Q. What are you taking there?

A. Taking architectural engineering.

Q. How long a course are you taking?

A. I plan to take the two year course.

Q. To finish this coming spring?

A. Finish this year.

Q. Had you planned any education beyond the high school when you went into service?

A. Yes, my father had a two year's education the same as I am having in a very similar school, before he entered his partnership with his father.

Q. Did you plan before you went into the service to go on to school? A. Yes.

Q. As you have done? A. Definitely.

Q. It was interrupted then by the service?

A. Yes.

Q. I show you Exhibit No. 7 and ask you if you signed [116] that. A. Yes, I did.

Q. And you knew what you were doing when you did it? A. Yes.

Q. That refers to a partnership agreement made January 1st, 1942. Do you remember when that was made? A. When this was?

(Testimony of Albert Eugene Trepte.)

Q. When the partnership agreement was made.

A. Yes, it was January 1st, 1942.

Q. Had you discussed it with your father before that time?

A. Yes.

Q. You remember giving your note for the purchase price?

A. Yes, I do.

Q. And the note has been entirely paid off out of the profits of the business.

A. Yes, I believe it was paid off in 1945.

Q. Have you used any of the profits of the business for yourself?

A. Yes, I have.

Q. We listed various checks in our stipulation, paragraph 21, that have been drawn against an account called Albert Eugene Trepte Withdrawals. I will call your attention to a few of them and ask you to tell what they are. For [117] instance, November 3, 1944, to Julius Sturz for \$76.88. What is that?

A. Right now I really don't recollect what that was.

Q. Well, I might tell you he is a tailor in San Diego.

A. Oh, yes. I remember I had a riding suit made at that time, yes.

Q. There is a check here on October 12, 1944, to Marshall Fridley, \$35.00. What is that?

A. That was for board for a horse.

Q. And there are a number of others for that same amount.

A. Yes.

Q. There is an item Sea, the Pacific Yachting Magazine, \$2.05. Is that yours?

(Testimony of Albert Eugene Trepte.)

A. That is right.

Q. The Coronado, \$97.38.

A. That is right.

Q. California Polytechnic School, \$10.00.

A. That is right.

Q. And September 7th, 1946, \$500.00. What is that for?

A. That was for my school. I transferred that money up in the bank up there.

Q. And a number of items, the first one March 28, 1947, payable to the Treasurer of the United States, \$6.40. What are those? [118]

A. That is for my insurance, my Navy insurance.

Q. On September 3, 1947, a charge to Eugene Trepte, \$150.00.

A. That was for some expense that I just can't remember now what that was.

Q. And at the same date one to you for \$600.

A. That was for this fall term at school. That was for—I remember now, those were two checks I think that were going to be transferred up to school.

Q. The two checks totalling \$750.

A. Yes.

Q. There are other withdrawals, payable to the United States Collector of Internal Revenue in various sums. Do you know what those are for?

A. Yes, taxes.

Q. And to the California State Treasurer, do you know what those are for?

(Testimony of Albert Eugene Trepte.)

A. No, I don't really right now, no.

Q. There are others made to the Franchise Tax Commissioner, various items. Do you know what those are?

A. No, I don't.

Q. Here is Walter E. Smith for \$425, September 27, 1944.

A. That was a road wagon I bought from Mr. Smith.

Q. To go with the horse? [119]

A. That is right.

Q. Do you have any allowance from your parents for your expenses?

A. No, I don't.

Q. You are paying that entirely yourself?

A. Yes.

Q. Have you had any allowance since you started in the Navy?

A. No, sir.

Q. The money you received as wages from the Navy, did you use it yourself, or send any to your parents?

A. No, I used it myself, and a lot of it went into my personal savings.

Q. You still have a personal savings account?

A. Yes.

Mr. Stone: You may cross examine.

Cross Examination

By Mr. Pigg:

Q. Mr. Trepte, what date did you say you went in the Navy?

A. February 28, I believe February 28 I was sworn in here in Los Angeles, 1944.

Q. 1944?

(Testimony of Albert Eugene Trepte.)

A. And June 7th I was discharged at San Pedro, 1946.

Q. When did you first enter the California Polytechnic [120] School?

A. I entered Cal Poly on September 11, 1946.

Q. You mentioned the fuel depot. To what does that refer?

A. The fuel depot, we were building a pier and sea wall.

Q. Where?

A. At the naval fuel depot in Point Loma.

Q. Is that near San Diego? A. Yes.

Q. In what year was that being built?

A. That was—the fuel depot I believe was in 1941.

Q. Mr. Trepte, I hand you what purports to be and is in fact your income tax return for 1942, is it not? A. Yes, sir.

Q. Calling your attention to an item of \$29,009.80. A. Yes.

Q. Do you know what that represents?

A. I imagine that is tax that I was subject to. Other than that, no.

Q. That is not called a tax. That is on item line 10, shows income.

A. Yes. Oh, I see, I see.

Q. What would you say?

A. That was what I—that was what my note was for, [121] I believe.

Q. Would you say that that item of \$29,009.80 is or is not the amount of the income of the Trepte

(Testimony of Albert Eugene Trepte.)

Construction Co. for 1942 attributed to you under the terms of the agreement of January 1, 1942, which is in evidence?

A. I believe that is what it is.

Q. And that shows a tax liability of \$12,413.21, does it not? A. Yes.

Mr. Pigg: I offer this return in evidence, your Honor, as Respondent's Exhibit I.

The Court: Any objection?

Mr. Stone: None.

The Court: Respondent's Exhibit I is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit I.)

By Mr. Pigg:

Q. I will save time. This, Mr. Trepte, is the return for 1943, is it not, bears your signature?

A. Yes, it does.

Q. And is your return for 1943? A. Yes.

Q. And that contains one item on line 9 of \$23,058.26. Is it or is it not a fact, if you know, that that represents [122] an item corresponding to the one mentioned on the 1942 return, so far as the Trepte Construction Co. is concerned?

A. I don't understand your question.

Q. Let me withdraw that. Would you say that that item represents the amount of income from Trepte Construction Co. for 1943 attributed to you?

A. To me, yes.

Q. Under the terms of the agreement of Janu-

(Testimony of Albert Eugene Trepte.)

ary 1, 1942? A. Yes.

Mr. Pigg: I offer this in evidence as Respondent's Exhibit J.

Mr. Stone: No objection.

The Court: Respondent's Exhibit J is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit J.)

By Mr. Pigg:

Q. Mr. Trepte, referring particularly to paragraph 21 of the stipulation of facts in this case, assuming that stipulation, particularly that paragraph, shows checks in these amounts and dates issued by the Trepte Construction Co., March 15, 1943, \$3,103.30, June 20, 1943. \$3,103.30; September 13, 1943, \$3,103.31 and December 10, 1943, \$3,103.30, and assuming that those items aggregate \$12,413.21 and that is the same amount as shown as tax due on the 1941 return, would you [123] say that those were the amounts of checks issued to you to pay the tax shown on your 1943 return?

A. Yes.

Q. Assuming that the same stipulation of facts shows a check issued and charged to your Withdrawal Account on March 13, 1944, for \$2,247.29, and that that is the same amount as is shown as the tax due on the 1943 return, Exhibit J, would you say that was the check issued in payment of that particular item of tax? A. Yes.

Q. Now, as to any and all other checks or items

(Testimony of Albert Eugene Trepte.)

shown in that stipulation, that paragraph, as identified, as being issued to the Collector of Internal Revenue, would you say that is or is not a fact, that those similar items were issued in payment of tax shown in a return made by you, an income tax return made by you? A. Yes.

Q. For some other year after or later?

A. Yes.

Q. Was your only source of income since 1942 the Trepte Construction Co.?

A. Yes, and the Navy.

Q. What amounts were attributed to you under the— A. Government.

Q. Excepting the Navy, we are talking about amounts [124] attributed to you under the terms of the agreement of January 1, 1942, were your only source of income since that date.

A. Yes.

Mr. Stone: If the court please, I believe that is a misstatement of the question, because he has already testified in 1942 he received salary for work on the Ryan building.

By Mr. Pigg:

Q. How much was that?

A. On the Ryan?

Q. Yes.

A. I know I was paid about, I know it was something like \$35.00 a week.

Q. For how long a period?

A. During the summer months between the spring and fall.

(Testimony of Albert Eugene Trepte.)

Q. And that was for what year? A. 1942.

Q. You will note in Exhibit I which is your 1942 return, there is a reference to an item of \$286.21. Is that or is that not the salary to which you have just referred as for the Rohr contract?

A. The Ryan.

Q. Ryan? A. Yes. [125]

Mr. Pigg: I think that is all.

The Court: Any further examination of this witness?

Mr. Stone: We would like to ask that he be excused from further attendance to go home to start to school tomorrow. Any objection?

Mr. Pigg: I don't have.

The Court: Have you finished with him?

Mr. Stone: We are through, yes.

Mr. Pigg: That is agreeable, your Honor.

The Court: This witness is excused from further attendance in this case.

(Witness excused.)

Mr. Stone: I will call Mrs. Trepte.

Whereupon,

MARGARET TREPTE,

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you tell us your name, please?

The Witness: Margaret Trepte.

(Testimony of Margaret Trepte.)

Direct Examination

By Mr. Stone:

Q. You are the wife of Walter Trepte?

A. Yes.

Q. And one of the partners of the Trepte Construction [126] Co.? A. Yes.

Q. When were you married to Walter Trepte?

A. In 1916.

Q. What was he doing for a business at that time? A. Working for his father.

Q. Was he a partner or just an employee?

A. No, just an employee.

Q. In what kind of work?

A. Oh, all kinds, pertaining to the construction business.

Q. What property did he own at the time you were married?

A. He didn't have anything.

Q. And you have lived together as husband and wife ever since that time? A. Yes.

Q. And whatever he has earned since that time you claim as community property? A. Yes.

Q. Do you remember the occasion of the discussions in regard to making a partnership and taking the boys in with Mr. Trepte? A. Yes.

Q. Do you know where that occurred? [127]

A. Well, at home we talked about it for quite awhile.

Q. When was that?

A. Well, it was in 1941, 1940. He talked about it a good deal as the boys grew up.

(Testimony of Margaret Trepte.)

Q. And you executed the partnership agreement dated January 1st, 1942, as one of the partners, did you? A. Yes.

Q. Did you know at that time that you were giving up nearly half of your community interest?

Mr. Pigg: I object to that. It calls for the conclusion.

The Court: Read the question to me, please.

(The question was read.)

The Court: Objection overruled.

The Witness: Yes.

Mr. Pigg: Exception.

The Court: Exception allowed.

By Mr. Stone:

Q. Did you favor making the partnership?

A. Definitely.

Q. Why?

A. Well, my husband was flying a good deal, and if anything should happen there would be somebody to carry on, and then I wanted it that way.

Q. Had the boys ever expressed any preference or [128] request for that kind of work?

A. Yes.

Q. In discussing the formation of the partnership, was there any discussion about its reducing taxes? A. No.

Q. Was there any mention of the precedent of Mr. Trepte and his father and their partnership?

A. Yes.

The Court: If you wish a record here, Mr.

(Testimony of Margaret Trepte.)

Counsel, you better have your witness keep her voice up.

Mr. Stone: I didn't hear the answer. Was there an answer?

The Witness: Yes.

By Mr. Stone:

Q. The reporter has to take it down and can't get the nod of your head. Before the partnership agreement of January 1st, 1942, was made, you read it, did you? A. Yes, I did.

Q. You knew what it contained? A. Yes.

Q. And signed it? A. Yes.

Q. Did you know that it had a provision for any of the partners to sell their interest to someone else? A. Yes. [129]

Q. And that Walter Trepte was made the manager of the business? A. Yes.

Q. And that the dealings under that partnership are controlled by the majority of the holdings of the partners? A. Yes.

Q. These other partners, Walter B. Trepte and Eugene Trepte are your sons?

A. Yes, they are.

Q. How long had Eugene talked and planned going into the construction business with his father?

A. Oh, all of his life, ever since he has grown up that is all he has wanted or talked about.

Q. Has he shown any particular interest in the business? A. Oh, sure.

Q. What?

(Testimony of Margaret Trepte.)

A. Well, he would work in the summer time, and when he is home on vacation goes down to the office or he is home at work looking over the books or would take trips with his father around the jobs.

Mr. Stone: I think that is all.

The Court: Read that answer for me, please.

(The answer was read.) [130]

Cross Examination

By Mr. Pigg:

Q. Do you know why your husband, Walter Trepte, was made manager of the business under the terms of the agreement of January 1, 1942?

A. Well, of course the business belonged to him when the business was started. He had always been the head of it.

Q. He was the only one among the four of you at that time who had the necessary education, training and skill, technical and otherwise?

A. Yes.

Q. To carry on the business of the type and character in which he was then engaged.

A. Yes.

Q. In what respect does that differ, if at all, since January 1, 1942, as compared to prior to that time?

A. Well, now the boys help him.

Q. The boys help him since when?

A. Well, you know Walter, since he has been working, since about 1935.

(Testimony of Margaret Trepte.)

Q. Then he helped him before January 1, 1942?

A. Yes.

Q. As well as afterwards?

A. Yes, but he was learning the business. [131]

Q. And he was paid a salary of \$35 to \$55 or so a week prior to January 1, 1942, wasn't he?

A. Yes.

Q. And he continued to receive the same amount or approximately the same amount week after week and month after month after January 1, 1942, didn't he?

A. Yes.

Q. What did Walter B. Trepte, your elder son, do in the way of helping his father after January 1, 1942, that he had not done before that date?

A. Well he did—of course, he was a little bit more skilled at that time in the business.

Q. At what time now are you referring to?

A. Well, than when he started in.

Q. In other words, he was more experienced on January 1, 1942, than he was in 1935?

A. Absolutely.

Q. And correspondingly I suppose the same thing would be true as of this date?

A. Yes.

Q. Using as your relative date, January 1, 1942?

A. Yes.

Q. Who actually prepared the written agreement or contract of January 1, 1942, do you know, Mrs. Trepte?

A. Beg pardon? [132]

Q. Who actually prepared the written agreement of January 1, 1942? Do you know who did that, who prepared that, the contract or agreement, written agreement?

(Testimony of Margaret Trepte.)

A. Well, I guess he did, we all did.

Q. Who prepared it, who drafted it?

A. The attorney.

Q. What attorney? A. Mr. Stone.

Q. Mr. Stone. And was Mr. Stone present at your discussions then, the preliminary discussions that led up to the signing of it? A. No.

Q. None of them?

A. No, not when I was there.

Q. Which ones were you at?

A. Well, we discussed it, my husband and I discussed it, more at the house out there.

Q. You didn't take part in the discussions at the office then?

A. I did in some of them but—

Q. Just happened to drop in on those occasions?

A. Well, I don't just remember that part.

Q. It is a fact, isn't it, that you left the whole matter to your husband's best judgment?

A. Yes, absolutely. [133]

Q. Whatever he decided and concluded was best to do, was all right with you, wasn't it?

A. Yes.

Q. You didn't actually study the terms of the agreement of January 1, 1942, for the purpose of determining whether you should or should not sign it, did you?

A. No, but I read it very thoroughly.

Q. You relied entirely on your husband's judgment about what was the best to be done?

A. Yes.

Mr. Pigg: That is all.

(Testimony of Margaret Trepte.)

Redirect Examination

By Mr. Stone:

Q. Were you at all influenced by what you wanted done for the boys?

A. No, not a bit, because we were in agreement about it, both wanted the same thing.

Mr. Stone: That is all.

Mr. Pigg: That is all.

The Court: Call your next witness.

(Witness excused.)

Mr. Stone: Mr. Walter Trepte.

Thereupon,

WALTER TREPTE,

called as a witness for and on behalf of the petitioners, having been first duly sworn, was examined and testified as follows: [134]

The Clerk: Tell us your name, please.

The Witness: Walter Trepte.

The Clerk: No middle initial?

The Witness: No.

Direct Examination

By Mr. Stone:

Q. How old are you? A. 54.

Q. What is your business?

A. General contractor.

Q. How long have you been engaged in that business?

A. Since—in the contracting business?

Q. Yes. A. Since 1917.

(Testimony of Walter Trepte.)

Q. And what were you engaged in before 1917?

A. In various crafts, working at the various crafts in the contracting industry.

Q. Who did you work for before 1917?

A. My father. [135]

Q. What was his name?

A. Morris Trepte.

Q. In San Diego? A. In San Diego.

Q. What change was made in 1917?

A. I became a partner with my father.

Q. And did he give you the interest or did you buy it or how did you acquire it?

A. I gave him a note for it, for the interest.

Q. Was the note paid? A. Yes.

Q. How, what funds?

A. Out of earnings. The note was—my father—may I—

Q. Yes.

A. My father had previously had a partner by the name of Ed Rambo, and I bought out his interest.

Q. Before you went to work as a partner with your father, what schooling did you have?

A. Two years of structural design, California School of Mechanical Arts, San Francisco.

Q. When did you obtain that schooling?

A. From 1910 to 1912.

Q. Then from 1912 on to 1917 was entirely spent working with your father? [136]

A. That is right.

Q. And for how long did your partnership with your father continue?

(Testimony of Walter Trepte.)

A. I don't—I think it was some—I think until 1928.

Q. And what arrangement—did he retire from the business?

A. I bought him out. I bought out his interest.

Q. Did you pay for that in cash or by a note?

A. In cash.

Q. From 1928 to 1942, was there anyone else associated with you in the business? A. No.

Q. What kind of construction work did you do largely in that period?

A. What is known as commercial construction and some engineering construction, road work and bridges.

Q. In this construction work, did your particular architectural engineering education give you any real assistance? A. Definitely.

Q. How?

A. Well, enabled me to grasp the fundamentals much faster than if I had not had that training.

Q. Were you able to do the engineering yourself on [137] some jobs that others would have to have architects for? A. That is right.

Q. Did you urge or guide your sons as to their education as they grew up?

A. Well, of course I hoped that they would join in our business. I influenced them all I could.

Q. And particularly as to the schooling that they should have? A. Yes.

Q. For instance, Gene's California Polytechnic School, did you discuss that with him before he

(Testimony of Walter Treppe.)

went there? A. Yes.

Q. Did you investigate it? A. Yes.

Q. Did you recommend it? A. Yes.

Q. Why?

A. Well, I had taken it up with the president of the San Diego State College who I thought was good, was an authority on schools, and he recommended that for a short term course that Cal. Poly. was the best that they had.

Q. Why did you form the Treppe Construction Company?

A. Well, I—firstly, because of the dangerous flying that we had to do to get to these off-shore Navy jobs; secondly, because of the business background; I had gone in [138] with my father and I felt that it was a good thing for my sons to do likewise.

Q. Was there any particular trip to San Clemente after which the question of partnership was discussed with anyone?

A. Well, one of the earlier trips that Mr. Golden and I took, we had a near crash in landing in a fog, and we discussed the question of what would become of this particular fixed fee contract we had with the Navy in the event of one or both of our deaths, so I told Mr. Golden that I had been considering having the boys go in partnership with me, and that I thought we should get one formed as soon as we could to carry on the business if anything happened to us.

Q. Was anything along that same line suggested to you by any of the government officers?

(Testimony of Walter Trepte.)

A. Well, one thing, Montgomery happened to—either Montgomery or Smith, I think, I was riding in the plane to and from there and they agreed that it would be very involved if anything like that happened, an accident.

Q. Do you know Mr. Smith's first name?

A. Henry Smith, Henry B. I think it is.

Q. Did you go frequently to San Clemente?

A. Yes, I went about once a week.

Q. How did they travel, what course to get there?

A. Well, they traveled north to Oceanside and to the control station and then westerly to San Clemente Island. [139]

Q. When was this occasion that you were speaking about when you were in the plane discussing the family partnership?

A. Well, it must have been the summer of 1941. We started the job in the summer of 1941. It must have been shortly after that.

Q. What contract was this San Clemente job under? A. Well, that is NOY-4025.

Q. With what department of the government?

A. The Bureau of Public Works, the United States Navy.

Q. Where was the work located that was done under that government contract?

A. All of the work?

Q. Yes.

A. Well, the original contract was for work, some \$2,700 worth of work. Most of that was on

(Testimony of Walter Trepte.)

North Island, which is in San Diego Bay, and that last work on that was completed, or that portion of the contract had to be completed roughly in a year's time. After that the contract was extended to include the Brown Field facilities of the lower end of San Diego Bay, the Otay Mesa Airfield facilities and Kearney Mesa Airfield facility and the San Clemente Island Airport facility. [140]

Q. All in that same contract?

A. That is right.

Q. How was the compensation paid under the contract, what compensation?

A. It was paid as a fixed fee, on a fixed fee basis that was determined by the officer in charge.

Q. What was the original fee on the original part of the contract?

A. Somewhere in the neighborhood of 3 percent, as I remember it.

Q. How was that paid to you, what kind of installments and where from?

A. Well, it was paid from the Bureau of Public Works at Washington — Bureau of Yards and Docks in Washington. I don't know whether it was — I can't say whether there was any definite or fixed intervals or not. It was paid in at—in installments, but the final, of course, count was not determined until the termination of the contract.

Q. Was that paid in separate checks or remittances from the payments that were made to you for the work as it progressed, meaning for the material and labor, was that paid you too under

(Testimony of Walter Trepte.)

the contract? A. Yes.

Q. They were paid separately, were they not?

A. Yes. [141]

Q. How did you collect your money on the payments for the labor and materials you put into it, weekly or monthly?

A. Well, I think it started monthly, and then as the job became larger I think it was bi-monthly, and it may have gotten down to weekly toward the last.

Q. What did you have to send to the government to get those payments?

A. The paid bills and the cancelled checks.

Q. How much did that contract eventually run into in dollars?

A. I believe it was between twenty-one and twenty-two million.

Q. Was the fee after this first two million of progress or what ever it was that you said was a little over 3 percent, was it the same rate of fixed fee after that for the rest of the contract?

A. No, we had—the Bureau of Yards and Docks determined that. We were told what we were to receive and we took it.

Q. Was it 3 percent?

A. No, I believe it was less than that, it averaged less than that.

Q. The last part of it got less and less, did it?

A. Yes, as the contract became larger the fee became [142] smaller.

Q. Well now, after your talk with Mr. Golden,

(Testimony of Walter Trepte.)

did you have further discussion with your family in regard to a partnership? A. Yes.

Q. And where and when?

A. Well, it was before—it was the fall of 1941, and of course we discussed it at home between the four of us.

Q. Were the boys questioned about their wanting to step into the business as partners?

A. Yes.

Q. And they wanted to?

A. Yes. I explained to them what an advantage it was to be taken in as a partner, because I had had the experience myself and found what a big advantage it was to take over a reputation for ability and integrity that you don't have to sweat for yourself, and they were able to see that and to appreciate it.

Q. You had reference to your experience with your father, taking over his—

A. That is right.

Q. Was there any discussion among you about making the partnership for the purpose of avoiding or reducing taxes?

A. No, I don't think taxes were mentioned. They were [143] a very minor thing then.

Q. And the war had not come on at that time?

A. No.

Q. Why did you make the notes 3 percent interest?

A. As I remember—I don't remember why, for what definite reason.

(Testimony of Walter Trepte.)

Q. Would you know why you didn't make it 6 percent?

A. Well, I wouldn't want to stick the boys.

Q. Now, at the time that partnership agreement was made, was Walter B. Trepte sufficiently educated in the business to take responsibility?

A. Yes.

Q. And what kind of responsibility could you give him?

A. He could take care of any of the office or accounting or hiring or personnel end of the work. He had an enlarged heart so he could not work out on the job the way Gene and I had worked.

Q. Do you think it is necessary for the boys, to have the proper education, to work in the dirty work of the business?

A. Well, I do to some extent, not as much as my father did.

Q. What is Walter B.'s position in the partnership now, what is his work?

A. Well, I would say he was assistant manager, assistant to me. [144]

Q. When you are gone he has the responsibility?

A. That is right. I was gone a considerable time this summer and he was—took my place, with a considerable amount of work on hand.

Q. You were doing considerable work during the summer?

A. As much as we were doing during the war or more.

(Testimony of Walter Trepte.)

Q. But for other than government?

A. Yes, I don't believe there were any government contracts this summer.

Q. In the partnership agreement among the items assigned to the partnership was this item: Naval air station job equity, \$88,458.88. What did that \$88,000 of the naval air station job equity consist of?

A. Well, working capital and the money owed us for labor and materials.

Q. None of that would be the profits of the job?

A. No.

Mr. Pigg: Your Honor, I have refrained from objecting for so long. I wish counsel would be instructed not to continue to lead his witness. This witness is an intelligent witness and does not need to be led. Let him testify, please.

The Court: I tell counsel quite often exactly in the same proportion that a witness is led his testimony must logically be discounted. [145]

By Mr. Stone:

Q. Do you have any other assets of your own other than those that you assigned to the partnership?

A. Yes.

Q. What character and what do they consist of?

A. Well, they were real estate and securities, liberty or government bonds.

Q. How long had Walter B. Trepte been working for you before the partnership was entered into?

A. Well, off and on since 1935.

Q. At the time the partnership was made, what

(Testimony of Walter Trepte.)

authority did he have in regard to the business, your business?

A. At the time it was, before?

Q. Yes, just at the time the partnership was made, yes?

A. Well, at that time he was—I would consider him as personnel, personnel man for our organization.

Q. Did he have any authority to sign checks?

A. Oh, yes.

Q. Did he sign any? A. Yes.

Q. After the partnership was made, was there any adjustment made by the partners as to a drawing account to equalize the different earning capacity of the partners?

A. Will you repeat that?

Mr. Stone: Read it please.

(The question was read.) [146]

The Witness: Yes.

By Mr. Stone:

Q. What was that?

A. The amounts, I couldn't give that.

Q. The amount that Walter drew, Walter B. Trepte drew, you would not know?

A. Well, it was around forty-eight hundred or five thousand a year.

Q. And how much did you draw?

A. Twenty, with the exception of one year when, I think it was 1944, when my business was slow, I think I drew ten.

Q. You mean ten hundred?

(Testimony of Walter Trepte.)

A. Ten thousand.

Q. And other years how much?

A. Twenty.

The Court: Meaning twenty thousand.

The Witness: Pardon me. Twenty thousand.

By Mr. Stone:

Q. And were those salary amounts deducted before figuring the profits that were divided between the partners? A. Yes.

Q. After the partnership was formed, did the boys have any right or exercise any right to draw any of the partnership funds for their own use?

A. Yes.

Q. And did they draw it? A. Yes.

Q. At the time the partnership was made had Gene, that is Albert Eugene Trepte, shown any aptitude for the construction business?

A. Yes.

Q. In what way could you see it?

A. Well, he had a natural ability to handle men and he had an interest in the engineering end of the business. I thought that he had exceptional ability as far as getting people and being able to—to get business, which is a big factor in the work.

Q. Since the partnership is made, has he taken any active part with you in the planning or management or operation of the business, other than these summers that he worked?

A. Well, he has shown a definite interest in what jobs we were doing and what the costs of the jobs were, how efficiently they were operated

(Testimony of Walter Trepte.)

and he has always shown an interest in the number of jobs we had, where they were and how they were progressing.

Q. Do you know of his ever going to any of those jobs to check up on them when he was not with you? A. Yes. [148]

Q. Have his questions afterward when you say he was there indicated why he went there?

A. Well, to enlighten himself.

Q. Has he been on the jobs with you any times?

A. Yes.

Q. Take any part in any discussion with you as to the character of the job, how it would be handled and carried out? A. Yes.

Q. I show you Exhibit 6. Is that your signature? A. Yes.

Q. And your wife's, Margaret Trepte's signature? A. Yes.

Q. Since that was executed on April 18, 1942 have you ever collected or used any part of Gene's earnings?

A. Well, repeat that. I didn't get that.

Mr. Stone: Will you read it Mr. Reporter?

(The question was read.)

The Witness: No.

By Mr. Stone:

Q. Or have you paid for his expenses, school expenses or any other expense?

A. No, the partnership did.

Q. Out of his part, was that?

A. Out of his part.

(Testimony of Walter Trepte.)

Q. How was the transition made from your individual [149] business of December 1941 to the partnership in January 1942? Was it a sudden change-over or was it gradual?

A. Well, I would say it was gradual. I was out of the home office most of that time, due to the fact that the Navy required me, this fixed fee contract, that I and Mr. Golden gave our individual—our own time to it, practically undivided. The change was probably gradual.

Q. Did you immediately print new stationery?

A. I don't believe so.

Q. Did you immediately print new checks?

A. No.

Q. What did you do?

A. Well, we have had stamps made and with the—we used to put these stamps that were all ready, or these checks and letterheads that were already printed, over stamped it with the Trepte Construction Company.

Q. You have another child, have you not, other than these two boys? A. Yes, a daughter.

Q. Was she considered at all in talking of this partnership? A. No.

Q. Why not?

A. Well, she could not—I didn't feel that she could lend any benefit to the partnership. [150]

Q. You have referred to the naval air station job, NOY-4025. Were there other government jobs that you were doing between 1940 and the end of the war? A. Yes, considerable.

(Testimony of Walter Trepte.)

Q. What were they?

A. Well, the first one was the fuel depot job, Navy fuel depot job at San Diego. The second one was a Defense Plant Job at Rohr Aircraft Company in Chula Vista. Then there was a sea water tunnel job that I think had governmental backing, I am not sure, for the San Diego Gas and Electric Company. Then we did several jobs for the Ryan Aeronautical Company, and I believe the Navy paid for one and the DPC paid for the other one.

Q. And what size were these jobs, the water tunnel for instance?

A. I think it was around three hundred thousand.

Q. And the Navy fuel depot?

A. \$750,000.

Q. And the Rohr Defense Plant Job?

A. Close to a million dollars.

Q. And Ryan?

A. Close to a million dollars.

Q. Those were taken under what names, those contracts?

A. Well, the Ryan jobs were under Trepte Construction Company. The fuel job and tunnel and the one for the Rohr [151] Aircraft Job were Golden Trepte Construction.

Q. On or about January 1, 1942 how large an organization did you have in your business, how many employees?

A. Oh, I would say around between 75 and 100.

Q. In the naval air station work of Golden & Trepte, how many were employed at that time?

(Testimony of Walter Trepte.)

A. I think the peak was 1500 men.

Q. Did Walter B. have any additional responsibility in connection with the naval air station job?

A. Yes.

Q. What was his share?

A. Well, he was—first he was with the time-keeping department, then he was assistant personnel man, and then he was equipment manager towards the last at the end of the contract, when we were having these hurdles at the job, and immediately had to get a very large amount of equipment, particularly rented equipment, and all of that he supervised as a representative.

The Court: We are now past 5:00 o'clock, gentlemen. We will be recessed until tomorrow morning at 10:00 o'clock.

(Whereupon, at 5:10 o'clock p.m., an adjournment was taken until 10:00 o'clock a.m., Tuesday, December 2, 1947.) [152]

Los Angeles, Dec. 2, 1947—10:05 a.m.

PROCEEDINGS

The Court: Proceed with the case on trial.

Whereupon,

WALTER TREPTE,

called as a witness for and on behalf of the Petitioners, having been previously duly sworn, resumed the stand and testified further as follows:

(Testimony of Walter Treppe.)

Direct Examination—(Continued)

By Mr. Stone:

Q. Mr. Treppe, when was the Defense Plant Corporation contract for the Rohr building that you mentioned entered into?

A. In the summer of 1942.

Q. Is your partnership, the Treppe Construction Company, still continuing as a going partnership?

A. Yes.

Q. Any plans of change of it in the future?

A. No.

Mr. Stone: That is all. You may cross examine.

Cross Examination

By Mr. Pigg:

Q. Mr. Treppe, concerning your employment and your partnership with your father in previous years as you have described it, what kind of business did you say that was?

A. The same business, construction business.

Q. The same business you have been in since about 19—well, since a long time prior to 1917?

A. He started the business in San Diego in 1895.

Q. That is, doing commercial contracting and engineering contracting?

A. That is right.

Q. What is the difference between the two?

A. Well, the building construction is commercial buildings in particular, building factories and warehouses. Engineering contracting is usually composed of road work, bridges, waterfront work.

Q. In every case it requires, for the purpose

(Testimony of Walter Trepte.)

of submitting bids to the person or the company or the government or otherwise, requires a knowledge of and skill in engineering and construction engineering, materials and labor markets, and prices and things of that kind?

A. That is right.

Q. What was the gentleman's name that you mentioned as having been a partner with your father prior to the time you became a partner?

A. Edward L. Rambo.

Q. I believe you said you bought his interest in 1917?

A. Well, I gave my father a note for his half of the business.

Q. You gave your father a note for whose half of the [157] business?

A. Well, for the other half that I took.

Q. What became of Rambo?

A. Well, he was I suppose reimbursed out of the money that my father must have bought him out and then taken my note for his half.

Q. Now, you said you bought Mr. Rambo's interest in your father's business at that time, didn't you?

A. Well, that is actually what happened. He left the business and I came in his place. I had been working as a superintendent for my father and for Rambo.

Q. In 1917 approximately how old were you?

A. I was 24.

(Testimony of Walter Trepte.)

Q. And how long prior to that time had you been working for your father in that business?

A. Well, since 1915. I ranched in the Imperial Valley for two years on some property my father owned.

Q. Was that for two or three years before 1917?

A. Yes.

Q. You were familiar with the transaction by which you became as you said a partner with your father at that time, weren't you? You knew how the transaction was consummated?

A. Well, yes.

Q. All right now, but what happened to Mr. Rambo? Did he take his—was there a division of the partnership [158] assets at that time, did he take his out separately?

A. I think he did. There was very little partnership property at the time.

Q. What did it consist of?

A. A small amount of equipment and a small amount of working capital.

Q. He could not have taken the equipment, could he, Mr. Trepte?

A. No.

Q. Then how did he take his interest or share out, if he did?

A. Well, my father must have given him a check.

Q. But you don't know?

A. No, I don't know.

Q. You don't really know how you acquired your interest as a partner in the business, do you?

(Testimony of Walter Trepte.)

A. Except that I did sign a note for what my father figured was the value of the business.

Q. Are there any books or records in existence now that would throw any light on the truth or accuracy of the testimony you have given concerning that transaction.

A. I don't know. I couldn't say definitely. I think there are, but I don't know.

Q. What and where are they?

A. If there are any such records I imagine my father has [159] them.

Q. Your father is still living?

A. That is right.

Q. At all events they are not in the courtroom?

A. What is that?

Q. At all events they are not in the courtroom?

A. No, that is right.

Q. Now, in 1928 I believe you said you bought your father's interest in the business for cash, didn't you?

A. Well, there was a cash—there was a division of property and then a cash adjustment. We naturally accumulated some real estate in our business transactions. He took some of it that way rather the real estate was divided and then an adjustment was made in cash. He took the bulk of the real estate, as I remember it.

Q. You mean that your father just withdrew from the business at that time and took a portion of the assets representing his agreed interest?

A. That is right.

(Testimony of Walter Trepte.)

Q. To whom did you make payment of cash as a result of the 1917 transaction, that is in payment of the note or otherwise?

A. Well, the note must have—I am quite sure I gave it to my father.

Q. You don't remember. Do you remember how much the [160] note was for?

A. No, I don't remember exactly.

Q. Your memory is very vague on that, isn't it?

A. Yes, it has been a long time.

Q. Prior to January 1, 1942 I believe you said that your own business, that is the business Walter Trepte Builders, had about 75 to 100 employees?

A. I would say so.

Q. Can you classify those employees as to the respective skills as between laborers and those who had either special training or abilities, and the approximate number?

A. Well, usually the skills—by skill you mean the foreman and supervisors?

Q. Yes, something like that.

A. Well, they usually constitute from 10 to 20 percent, depending on the type of work we are doing.

Q. Was the business divided up into departments, rather than one foreman did you have a department head or something like that responsible for any particular phase of the work, accomplishment or any particular part of the work or job?

A. Yes, there was always a superintendent for each job.

(Testimony of Walter Trepte.)

Q. And if you were working on two or more jobs, you would have superintendents for each job, wouldn't you?

A. Well, on a large one, yes, but if there were [161] several jobs that one superintendent could handle that he was dividing, he would handle three or four jobs or two jobs.

Q. Then the superintendent would have certain subordinates, that is, more or less technical men who would be charged with responsibility for the work of the laborers or the men that did the actual work?
A. That is right.

Q. Now these superintendents or the superintendent, as the case might be, they were responsible directly to you, were they not?
A. Yes.

Q. Worked under your supervision?

A. Yes.

Q. Under your direction?
A. Yes.

Q. You told them what to do and how to do it?

A. That is right.

Q. And that is equally true as to any work that either or both of your sons, Albert Eugene I believe and Walter B. did at that time, is it not?

A. Yes. It would be particularly true with Walter.

The Court: I am afraid that question doesn't mean much to me, Mr. Pigg. It is indefinite in my mind. If you want to show some facts, you better bring them out a little more definitely. I don't know what the witness means in response [162] to that question.

(Testimony of Walter Trepte.)

Mr. Pigg: Thank you, your Honor. I was turning over the same thing in my mind.

By Mr. Pigg:

Q. So far as Walter B. Trepte is concerned the work, the things he did or performed, as you have heretofore described—now let's rate this question up to including December 31, 1941—he did that work and performed those things under your supervision and direction, didn't he?

A. Yes.

Q. And that was likewise the situation, was the same after January 1, 1942 as theretofore?

A. For some time after that he took charge of the equipment of the North Island or NOY-4025 contract.

Q. When was that? When did he do that?

A. In 1942.

Q. And he took charge of what equipment?

A. All the grading equipment and trucks.

Q. You mean as far as maintenance?

A. Maintenance and rent and procural of equipment and the purchase of equipment.

Q. He did that under your supervision and at your direction, did he not? He consulted with you as to what he did?

A. Yes. [163]

Q. If he purchased any additional or new equipment he consulted you about it, did he not?

A. Well, there wasn't time on this particular job. His judgment was used a good deal.

Q. Well, if the equipment was any major item?

A. The officer in charge had to okay it, not I.

(Testimony of Walter Trepte.)

Q. You mean the naval?

A. The naval officer in charge, yes.

Q. Now as to Albert Eugene Trepte, I don't recall now, did he ever work for you prior to January 1, 1942?

A. Well, he worked in the summer of '41.

Q. Of what? A. Of '41.

Q. Whatever he did at that time he did under your supervision and direction, did he not?

A. That is right.

Q. Subject to your control? A. Yes.

Q. And in what respect, if at all, did that situation change so far as Albert Eugene is concerned after January 1, 1942? A. It didn't.

Q. Do you have the original of the government contract NOY-4025, Mr. Trepte? A. Yes.

Q. I hand you a document, Mr. Trepte, and ask you if that is the original of the contract, of the government contract, Navy Department contract number 4025, to which you have made reference?

A. Yes, it is.

Q. And is that signed on behalf of—first let me ask you what is the date of that contract, Mr. Trepte? A. July 6, 1940.

Q. And it was signed by whom on behalf of Walter B. Trepte Builder?

A. Walter Trepte.

Q. That is yourself? A. Yes, sir.

Q. And it was signed by whom on behalf of the government?

A. By the Secretary of the Navy. Is it Simpson?

(Testimony of Walter Treppe.)

Q. It looks something like that, Simpson. The signature is hard to read. Is that correct?

A. Yes.

Q. The signature is hard to read but it is signed as Acting Secretary of the Navy. That is sufficient, is it not? A. Yes.

Q. Now, will you look at this group of papers, Mr. Treppe, and tell me and tell the Court if this is an exact and true copy of the original contract which you have just [165] examined?

A. Yes, I would say it is.

Q. And it contains the same signatures, facsimilies—no, they are typed. Will you turn to the page—this signature you couldn't make out a while ago, looking at this copy does the name Louis Compton, does that explain— A. Yes.

Q. He was the government official who signed as Acting Secretary of the Navy? A. Yes.

Q. Do you say this is a true copy of the contract? A. Yes.

Mr. Pigg: I will offer this copy as Respondent's Exhibit K.

The Court: Any objection to this instrument?

Mr. Stone: No.

The Court: Respondent's Exhibit K is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit K.)

By Mr. Pigg:

Q. Now, Mr. Treppe, I will turn to Exhibit K. Was that a contract on which you acting as Walter

(Testimony of Walter Trepte.)

Trepte builder was engaged at that time as distinguished from the Golden & Trepte Construction Company, or is that a Golden & Trepte [166] Construction contract?

A. That is a joint venture formed by M. H. Golden contractor and Walter Trepte.

Q. Then you obtained this contract on the date that you have mentioned, on July 11, 1940, and was it on or after that date that you entered into the contract with—I mean the partnership arrangement with Mr. Golden?

A. Well, there must have been a partnership formed before the contract was signed.

Q. Mr. Golden didn't sign this contract, did he?

A. Yes.

Q. Did he? A. M. H. Golden.

Q. I see. This was a Golden & Trepte Construction Company contract?

A. Known as a joint venture, yes, for the purpose of handling this job.

Q. Was the Golden & Trepte Construction Company engaged on any other contract than this one at any time during the years 1940—let us say from the date of this contract until the close of the year 1943? A. Yes, sir.

Q. What other contract?

A. An addition to the Rohr Aircraft Plant in Chula Vista. The contract was with the DPC Corporation. [167]

Q. DPC, what does that mean?

A. Defense Plant Corporation.

(Testimony of Walter Trepte.)

Q. That is a government contract also?

A. Yes, sir.

Q. And do you have that contract in the court-room? A. Yes, I believe so.

Q. Mr. Trepte, there is a group of papers which purports to be a duplicate original, I believe it is a carbon copy bearing actual signatures. Is that the contract to which you have just referred?

A. Yes.

Q. And this is signed by whom on behalf of the contractors, that is Golden & Trepte?

A. Walter Trepte and M. H. Golden.

Q. What is the date of it?

A. June 30, 1942.

Q. Can you tell who signed on behalf of the government?

A. Fred H. Rohr, president of the Rohr Aircraft Company.

Q. But the cost and payments that were made under that contract were made by the Defense Plant Corporation?

A. Yes, the Rohr Aircraft were acting for and on behalf of the Defense Plant Corporation.

Q. When was the work on that contract begun and when was it completed? [168]

A. It must have been begun shortly, the day after the contract or the day the contract was signed. I don't know whether it was completed in 1942 or not.

Q. Was it completed in 1943? A. Yes.

Q. What was the amount, the approximate

(Testimony of Walter Trepte.)

amount of total payments under that contract, Mr. Trepte?

Mr. Stone: Page 2, Paragraph 2.

The Witness: The total amount is \$644,339.

By Mr. Pigg:

Q. That is the figure shown in the second paragraph of page two? A. That is right.

Q. Were there any additions or supplements to that to increase the payments?

A. I couldn't answer that. I think there were, however.

Q. Well, now, going back for a moment to the contract number 4025, the navy contract which is dated, I believe, July 11, 1940, when or approximately when was the work under that contract completed, including any additions or supplements and so forth?

A. I couldn't answer that definitely.

Q. Can you answer as to the year?

A. No, because it was dragged out. I think it was in the early part of 1944, however. [169]

Q. Not all completed, however, prior to December 31, 1943, is that correct?

A. I would say so.

Q. Now, what were the actual or approximate total payments made by the government under that contract? A. This one?

Q. 4025.

A. Approximate twenty-one million.

Q. Will you tell me if this group of papers is a true copy of the cost-plus fixed fee contract which you have identified as being dated—

(Testimony of Walter Trepte.)

A. June 30, 1942.

Q. June 30, 1942? A. Yes.

Q. It is? A. Yes.

Mr. Pigg: I would offer this copy of the contract as Respondent's Exhibit L. Is there any objection?

Mr. Stone: No objection.

The Court: Respondent's Exhibit L is admitted in evidence.

(The document above-referred to was received in evidence and marked Respondent's Exhibit L.)

By Mr. Pigg:

Q. Was the Golden & Trepte Construction Company [170] engaged on any other government contract during any part of the year 1942?

A. Yes, the fuel depot contract for the navy.

Q. How about 1943? A. How is that?

Q. How about the year 1943?

A. I don't believe there were any in the year 1943.

Q. Do you have the copy or the original of the fuel depot contract?

Mr. Stone: I din't have that. We were not able to find it. I think it was with Mr. Golden, and Mr. Walter Trepte was not able to find it.

By Mr. Pigg:

Q. What was it, a cost—

A. No, it was a lump sum.

Q. How much was the total payment under that contract?

(Testimony of Walter Trepte.)

A. In the neighborhood of—over seven hundred thousand dollars.

Q. What year, do you remember, was that contract completed? A. In 1942, I am quite sure.

Q. The Golden & Trepte Construction Company engaged on no other government contract in either 1942 or 1943 than the three you have mentioned?

A. Not on a government. They built water tunnels for [171] the San Diego Gas and Electric Company. Whether the government had any part of that I don't know. It may have been, but the contract was signed with the gas company.

Q. Did I correctly understand your testimony yesterday afternoon to be that it was your understanding that the Navy Department did pay the cost of that contract?

A. No, I said I thought the government had some interest in it, but we were paid by the gas company direct.

Q. Does that complete all the contracts, or were there others? A. No, I believe that is all.

Q. Now, was the Golden & Trepte Construction Company engaged on any similar construction contract for anyone other than the government during either of the years 1942 or 1943 other than as you have mentioned?

A. We might have done a contract for Rohr in addition. I am not positive whether I was doing work at the time for Rohr or Ryan and several other of my customers, and I don't know, I couldn't say whether Golden participated in those. He didn't

(Testimony of Walter Trepte.)

in any of the Ryan contracts. It was just a gesture of good will on my part. It was not necessary.

Q. Did you do some work for Mr. Rohr or Mr. Ryan as the Trepte Construction Company after January 1, 1942? A. Yes.

Q. To the extent that your testimony on direct [172] examination related to or referred to work done for either of those gentlemen, was that done, the work performed, by the Trepte Construction Company as distinguished from Golden & Trepte?

A. Yes, sir.

Q. Were those large contracts or relatively small compared to these two here, now represented by Exhibits K and L?

A. They were large, relatively the same size.

Q. They were private individual contracts, the government not interested in those, is that right?

A. Well, on the last job that we did for the Ryan Company, the navy paid for all of the improvements.

Q. That was the Ryan Aeronautical contract you mentioned yesterday afternoon?

A. Yes, sir.

Q. That was a navy contract?

A. Yes, that was one—well, we had a crew at Ryan's from 1939 I think until the end of the war, so this navy contract was the only one that the government paid us. Any of the rest of them the Ryan Aeronautical Company paid direct. The navy contract was about \$100,000.

Q. Lest we might forget now, as to the Golden-

(Testimony of Walter Trepte.)

Trepte Construction Company I believe you said yesterday that approximately as of January 1, 1942 they had approximately fifteen hundred employees. That is about right? [173]

A. I said that was the peak.

Q. When did you reach the peak?

A. I don't know whether the peak was in early—I think it was in early—right after December 7th, 1941.

Q. Not long after Pearl Harbor?

A. That is right.

Q. So far as the classification is, that is, the superintendents and the manner of performing the work on these contracts is concerned, and as to the number of employees and the superintendents and responsibilities of the employees and so forth, would your testimony be the same so far as the Trepte-Golden Construction Company is concerned as it was with respect to the first company, that is the Trepte Construction Company, about which you were questioned a little while ago?

A. Yes, sir.

Q. Mr. Trepte, I will hand you Petitioner's Exhibit 1 and call your attention particularly to page number 2 and to the last items under the heading of assets, and particularly to the item naval air station depot equity \$88,458.88. What relationship, if any, does that have to this contract number 4025?

A. Well, it was the working capital that was advanced to run the job out of our concern.

Q. That represents the working capital that

(Testimony of Walter Trepte.)

[174] Golden-Trepte at that time had put in?

A. Well, that is my share of it, not Mr. Golden's share. It varied.

Q. And those payments were made under that contract, I believe you said, two in a month, is that right?

A. Yes, sir.

Q. And depending on the dates on which progress reports or estimates as to percentage of completion were made or submitted to the contracting officer?

A. Well, in this particular case we paid the bills and got the receipts and they reimbursed us within ten days.

Q. Within ten days?

A. It was a fixed fee plus a net cost.

Q. So that the \$88,000 represented approximately the amount necessary to carry on under—

A. Yes, material and labor.

Q. For material and labor under that contract?

A. Yes, sir.

Q. Mr. Trepte, isn't it a fact that your son Walter B. Trepte has never shown any real interest in the business, that is, at least from its technical aspects, engineering features?

A. I wouldn't say that. He certainly shows an interest in the operation of the business. His inclination is toward the accounting and the office end of it and the equipment [175] end of the business.

Q. Has he ever studied engineering, structural engineering or otherwise?

A. Well, he took an economics course.

(Testimony of Walter Trepte.)

Q. Has he ever studied accountancy?

A. He must have been—he took an economics, started in an economics course at State College in San Diego.

Q. You say he must have. You don't know whether he did or not?

A. No, I couldn't say definitely.

Q. You heard his testimony yesterday as to the extent of his knowledge of bookkeeping, didn't you? A. Yes.

Q. Now, referring to your trips with Mr. Golden in the summer or fall of 1941, from where to where did you say those trips were made?

A. The trips were made from the airfield at North Island to the temporary landing strip at San Clemente Island, off the coast of San Diego County.

Q. What distance would you say?

A. Well, the airline distance would be about around 90 miles, but we flew probably 150 miles on the course to get there.

Q. Now, as I understand your testimony, the inference of it or the purport of it was that both you and Mr. Golden engaged in flying under these hazardous conditions, and you [176] discussed the possible extent to which your business was jeopardized by the chance of accident; is that generally what you meant? A. Yes.

Q. And that because of these hazards you were concerned as to what might happen to the fixed fee contracts on which you were then engaged?

A. That is right.

(Testimony of Walter Treppe.)

Q. What was the nature of that concern, Mr. Treppe?

A. Well, we were concerned as to protecting the assets of the company if a trustee or someone operated the contract, it might not have been satisfactory to the navy.

Q. In other words, you were concerned as to what might happen to the profit which had been made or might or was calculated to be earned under the contract?

A. And our reputation.

Q. And the welfare of the respective families?

A. Yes, and the reputation of the business. If the contract had been cancelled it would have reflected on—

Q. Your primary interest was to conserve your interest in those contracts for the benefit of your respective families, is that what you mean?

A. I would say so.

Q. To what extent, if at all, were you concerned as to what might happen as to the completion of those contracts if [177] anything should happen to either you or Mr. Golden?

A. Just as much as we were concerned about the family, for the contract called for completion of it.

Q. You realize, of course, if such a catastrophe should happen someone else would have to take over the contracts, don't you?

A. That is right, and both Mr. Golden and myself felt that our sons should take over.

Q. So that this family partnership arrangement is the device chosen by you as a means to carry into

(Testimony of Walter Trepte.)

effect your plans for the conservation of the family welfare?

A. And the carrying on of this job particularly.

Q. Well, you knew that Mr. Walter B. Trepte was not competent to carry on that contract in the event of your death, didn't you?

A. No, sir, I think he has—would have had the ability at that time. He has certainly showed himself to have the ability since then.

Q. What do you think as to the other son, Eugene Trepte, as of that date?

A. Well, I don't believe he could have carried—

Q. Had Walter B. Trepte ever prior to January 1, 1942 assembled the data necessary for the preparation and submission to the government or any person or concern any bid for construction work of the character you have described? [178]

A. This particular job?

Q. These jobs or any other similar construction work.

A. He had helped, yes.

Q. He helped. Who did he help?

A. He helped me and he helped our estimators.

Q. Your estimators are salaried employees, are they not?

A. Yes, sir.

The Court: As of what date are you directing that question?

Mr. Pigg: As of January 1, 1942, particularly, your Honor, immediately preceding that date.

The Court: Proceed. Was your answer given as to that date?

The Witness: Yes, sir. Yes, your Honor.

(Testimony of Walter Trepte.)

By Mr. Pigg:

Q. Now, relating the same question to any other time between January 1, 1942 and December 31, 1943, what would your answer be?

A. May I have the first question read?

The Court: I think you better make that more definite. I doubt whether the witness heard it. I am not sure that I did.

Mr. Pigg: I will withdraw that question and restate it. [179]

By Mr. Pigg:

Q. To what extent, if at all, during the period January 1, 1942 to December 31, 1943 had Walter B. Trepte assembled the data necessary to the preparation of bids for construction work of the type or nature we have been discussing here?

A. He assisted in the same manner. I was the final check.

Q. In other words, it was the same after January 1, 1942 as it had been theretofore?

A. Except that he was handling larger jobs than he had before, himself.

Q. Just how did this family partnership arrangement idea originate with you, Mr. Trepte?

A. Well, my wife and I had been talking about it for years previous. I had had the same sort of partnership with my father, and we had—my father was able to build up the good will and integrity of the business during the period that—prior to the time I was taken in as a partner and up to the time I bought him out. I might say that I kept the good will and the integrity of the business, and we felt

(Testimony of Walter Trepte.)

that it should be continued by taking in these sons that were able to become partners.

Q. In what way did you feel or believe that the integrity of the business was fortified by bringing in the two [180] sons in the manner in which they are shown to have been brought in?

A. Well, I can't say bringing in the sons would do so. I referred to the integrity and ability that my father and I had built up, good will, and I could expect my sons to do likewise, and I feel that they are having the same advantage that I had from my father's good will that had been built up.

Q. In other words, you want to pass that on to them?

A. That is right. I might say that we have built six or seven buildings for the same corporation, so there must have been a measure of good will built up, to have done that.

Q. Is it or is it not a fact that as of about that time, and referring particularly to a matter of six months or so before January 1, 1942, that you had heard of other similar arrangements that had been put into effect, family partnerships?

A. No, except the one that my father and I had.

Q. That is the only one you ever heard of?

A. No, no, but that was the background of it.

Q. You knew it was being done more as a general thing in this area or section of the country, did you not, Mr. Trepte?

A. No, sir.

Q. You knew it was frequently being done, didn't you?

A. Subconsciously, I suppose I did. [181].

(Testimony of Walter Trepte.)

Q. You also knew the tax effect of it, didn't you?

A. Well, in 1941 I don't believe there was a very large tax.

Q. Did you mean to testify on direct examination, yesterday afternoon, that you had never discussed the matter of forming a family partnership with any attorney or any accountant prior to the time that you decided to go through with the plan?

A. No, it was afterwards.

Q. You mean it was not until after you had made your decision that you talked or discussed that with any attorney or accountant?

A. That is right.

Q. You are positive of that? A. Yes.

Q. You are positive that you never discussed the tax angles or effect of such an arrangement with Mr. Essenhoff, what is his name, Carl Essenhoff?

A. Carl Essenhoff. He is our accountant.

Q. A CPA is he not? A. CPA, that is right.

Q. Who worked for you prior to January 1, 1942? A. Yes.

Q. And afterwards. When did you first consult an attorney about drawing up this partnership agreement, Mr. [182] Trepte?

A. Well, it must have been the latter part of 1941.

Q. Whom did you consult? A. Mr. Stone.

Q. When was the document actually drawn up and executed?

(Testimony of Walter Trepte.)

A. I couldn't say the exact date, but it was around the first of the year.

Q. Did you tell Mr. Stone the substance of the provisions you wanted incorporated in the agreement?

A. Yes. Mr. Stone had been my father's and my attorney prior to then. He handled the dissolution of our partnership in 1928.

Q. Did he have anything to do with the transaction by which you stated you bought the interest of Mr. Rambo, what is the name?

A. Rambo. No, sir.

Q. In 1917?

A. No, sir. There was no attorney. There were not enough assets to pay for an attorney.

Q. Now, on your suggestion that you didn't think the tax rates were very high late in 1941 or the beginning of 1942, you knew, did you not, Mr. Trepte, that there had been two revenue acts passed during the year 1940, one known as the first revenue act of 1940 and one as the second revenue [183] act of 1940?

A. I don't remember paying any particular attention to it.

Q. You knew that the tax rates were going up at that time, didn't you?

A. I suppose I did, yes.

Q. In work of the character you have described you would be reasonably familiar with the tax, the amount of tax that you would need to pay out of the earnings or profits of the operation, would you not?

A. From prvevious experience, yes.

(Testimony of Walter Trepte.)

Q. From previous experience?

A. Yes, certainly.

Q. Assuming that the first revenue act of 1940 was enacted on June 25, 1940 and that the second one was enacted on October 8, 1940, those are matters that normally would come to your attention and notice in the course of your business, are they not?

A. Yes, I think so.

Q. And assuming also that there was an excess profits amendment in 1941 and that the act did become law and was enacted on March 7, 1941, that is also a matter with which you would be reasonably familiar at that time, is not?

A. I suppose so.

Q. And assuming that there was considerable publicity [184] in the press and business circles in general as to the new revenue act, the war revenue act, which Congress then had under consideration that later became the revenue act of 1942, in the business that you were engaged would you have reason to be familiar and to have at least a speaking acquaintance with the possibilities of such an act?

A. Yes.

Q. The very proximity of the date of this partnership agreement to the Pearl Harbor date of December 7, 1941 would have served to impress those matters upon your mind, would it not, Mr. Trepte?

A. Well, it would also impress on my mind the need of having someone to carry on the business.

Q. You mean by that that it was your purpose

(Testimony of Walter Trepte.)

that your wife and two sons would carry on the business if anything happened to you?

A. That is right.

Q. You knew that none of them had been trained for such an undertaking at that time, didn't you?

A. No, sir, my oldest son was trained and he had the ability to carry on if he had to. As long as I was there to carry the ball he naturally could not take my place.

Q. Walter B. Trepte was paid a salary as such for what ever periods that he worked for you prior to January 1, 1942, was he not? [185]

A. Yes.

Q. So far as amounts withdarawn by him were concerned, after that date, for the next two years after that date, which were entered in the account captioned Walter B. Trepte, withdrawals, he continued to receive the same or substantially the same amounts per week and per month during the two years following January 1, 1942, is that right?

A. Yes. He had the authority to withdraw anything more that he wanted, though.

Q. How did he acquire that authority?

A. Well, from the consent of my wife and I and his brother.

Q. You mean you, your wife, and your other son did actually consent that he might do so?

A. That is right.

Q. Was that consent reduced to writing or just was it an oral understanding?

(Testimony of Walter Trepte.)

A. No, it was an oral understanding. It was a written understanding, though, as far as the bank was concerned. My wife and I had to—and my son had to sign the signature card at the bank, to give him authority to sign checks.

Q. I was just coming to that. So far as any checks, the company checks were signed by Walter B. Trepte, was his authority for the signing of the checks given in accordance with provisions of the agreement of January 1, 1942? [186]

A. Yes. The partnership agreement you refer to?

Q. Yes, the partnership agreement.

A. Yes.

Q. In other words, the majority interest partners authorized him to sign those checks?

A. Yes.

Q. And authorized the bank to honor—

A. His signature.

Q. His signature? A. Yes, sir.

Q. Was anyone else authorized to sign checks on behalf of the company?

A. At various times, yes, particularly on jobs when I was supposed to be away from the city of San Diego I would have to have another signature to carry the business on efficiently.

Q. What kind of work did you understand Mr. Stone to have reference to yesterday when he mentioned the dirty work in connection with the business which you have described?

A. Well, I imagine working with tools, with a shovel or a pick.

(Testimony of Walter Trepte.)

Q. Is that all pick and shovel work?

A. Or carpenter tools or cement finisher's tools or plasterer's tools.

Q. As distinguished from one competent to plan and [187] supervise the performance of such work, you understand? A. No, I don't.

Q. You mean the actual doing of those manual jobs as distinguished from a person qualified to supervise and plan the construction of such jobs?

A. I don't quite understand the answer you want.

Mr. Pigg: Well, it is not important. We can strike it. I believe that is all, your Honor.

Mr. Stone: I wonder if counsel would be willing to stipulate that the excess tax amendment that he referred to of March 7, 1941 applied only to corporations and not individuals.

The Court: That is a matter of law. I will take that, of course.

Mr. Stone: And the fact that the 1942 revenue act that he spoke of was passed October 21, 1942?

The Court: That is also a matter of law, of which I will take judicial notice.

Redirect Examination

By Mr. Stone:

Q. Was this navy contract on North Island made by you by a bid? A. No.

Q. How was it?

A. It was negotiated between the commandant of the [188] eleventh naval district together with the public works officer, to handle a given amount of construction work at North Island.

(Testimony of Walter Trepte.)

Q. Did you and Golden apply for the job, or did the government ask you to do it?

A. The government asked us.

Q. They picked you, then. A. Yes, sir.

Q. Mr. Pigg has asked you in regard to the activities of Walter B. Trepte in procuring equipment on the North Island job. Do you know of one occasion or more where he went out of the state to procure equipment?

A. Yes, one of the larger procurement jobs was to take over several hundred thousand dollars worth of equipment out of the CCC camps at that time in the state of Arizona. It was a transaction between the navy and the CCC authority.

Q. When was that done?

A. I think it was 1942.

Q. Who picked Walter B. Trepte to do that job? A. The officer in charge.

Q. And he did it satisfactorily?

A. Yes.

Q. What was the volume or value of the equipment that was purchased?

A. There were several hundred thousand dollars worth or more. [189]

Q. Mr. Pigg asked you in regard to your duties as the superintendent or the manager of the employees, on bids and various things. Were your duties as sole owner of the business before January 1, 1942 carried on the same as your duties as manager of the partnership after that? A. Yes.

Mr. Stone: That is all. No further examination.

(Testimony of Walter Trepte.)

The Court: Any further questions of this witness?

Mr. Pigg: I think that is all, your Honor.

The Court: I want to ask you one or two questions, to clear up one proposition that I do not think has been explained to me clearly. You have been asked a time or two, Mr. Witness, about your consideration of taxes or escape of taxes—I am not trying to use the same words that may have been used in forming this partnership arrangement, and your answer was in effect that taxes were not heavy then or something to that effect, I believe. Is that about what you answered?

The Witness: Yes.

The Court: Well, that does not exactly answer the question, it seems to me, if taxes are heavy or light, comparatively speaking. What I want to know is to what extent, if any, you took taxes into consideration in forming this partnership arrangement?

The Witness: We didn't take them into consideration. [190]

The Court: Were they ever discussed at all?

The Witness: Not until the—after it was formed and Mr. Essenhoff brought the matter up.

The Court: How long after it was formed was it before he brought the matter up?

The Witness: Well, when he came in the office I imagine in March to audit the books of the previous year.

The Court: March of what year?

(Testimony of Walter Treppe.)

The Witness: Of 1942.

The Court: State to what extent, if any, you took into consideration the matter of dividing up income by forming a partnership arrangement?

The Witness: Well, I don't think we considered it particularly. The main thing was to have the boys in the business, to carry on in the case of my death.

The Court: You say you don't think you considered it particularly. That is rather a general answer. Tell me more particularly about that, whether you did or did not.

The Witness: We did not.

The Court: That is all I wanted to ask.

Mr. Stone: The Petitioners rest.

The Court: The Petitioners rest. What has the Respondent?

Mr. Pigg: The Respondent rests, your Honor.

[Endorsed]: T.C.U.S. Filed Dec. 19, 1947. [191]

In the United States Court of Appeals for the
Ninth Circuit

Docket No. 12515

WALTER TREPTE,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

Docket No. 12516

MARGARET TREPTE,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

ORDER

Upon joint motion, it is ordered:

1. That a single consolidated transcript of record on review in the above-entitled proceeding shall be sufficient.

2. That these proceedings be and they are hereby consolidated for briefing, hearing, argument and decision.

3. That the original exhibits in the above-entitled causes, consisting of Petitioner's Exhibits 1 and 4 through 16 and 21, Respondent's Exhibits G through L, and Joint Exhibits 2-A, 3-B, 17-C, 18-D, 19-E and 20-F, instead of being fully set forth in the transcript to be certified by the Clerk of The Tax Court of the United States to the Clerk

of the [192] United States Court of Appeals for the Ninth Circuit, may be transmitted by the Clerk of the Tax Court to the Clerk of this Court, said exhibits, however, to remain in the custody of the Clerk of the Tax Court until fifteen days prior to the hearing before this Court and, upon direction and at the expense of counsel for petitioners, to be then transmitted by the Clerk of the Tax Court to the Clerk of this Court.

4. That said exhibits need not be printed in the record on review herein but may be referred to by counsel in their respective briefs and on oral argument, or reproduced, in whole or in part, in an appendix to their respective briefs, and considered by the Court with the same force and effect as if included in the printed record on review.

5. That the time within which to file the record on review in the above-entitled proceedings with this Court be, and the same is, extended to and including November 16, 1948.

6. That the Clerk of this Court transmit a certified copy of this order to the Clerk of The Tax Court of the United States to be by him incorporated in the transcript of record on review herein.

Done at Los Angeles, California, this 28th day of Sept., A. D., 1948.

ALBERT LEE STEPHENS,
U. S. Circuit Judge.

[Endorsed]: Filed Sept. 29, 1948. Paul P. O'Brien, Clerk.

A true copy. Attest: Sept. 29, 1948. Paul P. O'Brien, Clerk. (Seal.)

[Endorsed]: T.C.U.S. Filed Oct. 4, 1948. [193]

[Title of Causes Nos. 12515-16.]

DESIGNATION OF CONTENTS OF RECORD
ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled causes in connection with the Petition for Review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by Walter Trepte and Margaret Trepte, the above-named petitioners:

1. The docket entries of all proceedings before the Tax Court of the United States.
2. Petitions (omitting Exhibits attached thereto).
3. Answers.
4. Memorandum, Findings of Fact and Opinion of the Tax Court promulgated May 28, 1948.
5. The Decision of the Tax Court entered on May 28, 1948.
6. Petition for Review filed on August 23, 1948.
7. Notice of filing Petition for Review filed on August 23, 1948.
- 7½. Stipulation of fact filed December 1, 1947.
8. From the official transcript of oral testimony:
 - (a) The testimony of Walter B. Trepte which appears [194] on pages from 31 to 65, inclusive;
 - (b) The testimony of Albert Eugene Trepte which appears on pages 65 to 79, inclusive;

(c) The testimony of Margaret Trepte which appears on pages 79 to 87, inclusive;

(d) The testimony of Walter Trepte which appears on pages 87 to 144, inclusive.

9. This Designation of Contents of Record of Review.

10. Notice of filing Designation of Contents of Record on Review and the Admission of Service thereof.

Said transcript to be prepared as required by law and the rules of the United States Circuit Court of Appeals for the Ninth Circuit.

On September 28, 1948, the United States Circuit Court of Appeals for the Ninth Circuit entered an Order which sets forth in detail the manner in which the original Exhibits set forth below are to be transmitted to the Clerk of the aforesaid Circuit Court:

Petitioners'—Nos. 1, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, and 21;

Respondent's—G, H, I, J, K, and L;

Joint Exhibits of Petitioners and Respondent—2-A, 3-B, 17-C, 18-D, 19-E, and 20-F.

/s/ GEORGE H. STONE,
Counsel for Petitioners.

/s/ WM. D. MORRISON,
Counsel for Petitioners.

(Acknowledgment of Service.)

[Endorsed]: T.C.U.S. Filed Oct. 11, 1948. [195]

[Title of Causes Nos. 12515-16.]

CERTIFICATE

I, Victor S. Mersch, clerk of The Tax Court of the United States, do hereby certify that the foregoing pages, 1 to 195, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 22nd day of October, 1948.

(Seal) /s/ VICTOR S. MERSCH,
Clerk, The Tax Court of the United States.

[Endorsed]: No. 12078. United States Court of Appeals for the Ninth Circuit. Walter Trepte and Margaret Trepte, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed October 28, 1948.

 /s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals for the
Ninth Circuit

No. 12078

WALTER TREPTE, MARGARET TREPTE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STATEMENT OF POINTS ON WHICH PETI-
TIONERS INTEND TO RELY AND DESIG-
NATION OF PARTS OF THE RECORD
NECESSARY FOR CONSIDERATION

To the Honorable Paul P. O'Brien, Clerk of the
United States Circuit Court of Appeals for the
Ninth Circuit:

Petitioners adopt as their points on appeal the
assignments of error included in the petition for
review within the transcript of record.

The petitioners designate for printing, the entire
transcript of the record, except Exhibits attached
to the petition of Walter Treppe, Tax Court Docket
No. 12515 designated as Exhibits A, B, C and D
and the Exhibits attached to the petition of Mar-
garet Treppe, Tax Court Docket No. 12516 desig-
nated as Exhibits A, B, C and D for the reason
these exhibits are included in the order dated Sep-

tember 28, 1948 issued by this Honorable Court and are designated therein as Petitioners Exhibits 1, 4 and 5 and Joint Exhibits 2-A and 3-B.

Dated November 3, 1948.

 /s/ GEORGE H. STONE,
 Counsel for Petitioners.

 /s/ WM. D. MORRISON,
 Counsel for Petitioners.

[Endorsed]: Filed November 4, 1948. Paul P.
O'Brien, Clerk.

United States Court of Appeals

For the Ninth Circuit

WALTER TREPTE and MARGARET TREPTE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR THE PETITIONERS

GEORGE H. STONE,

1004 San Diego Trust & Savings Building,
San Diego 1, California,

Counsel for Petitioners.

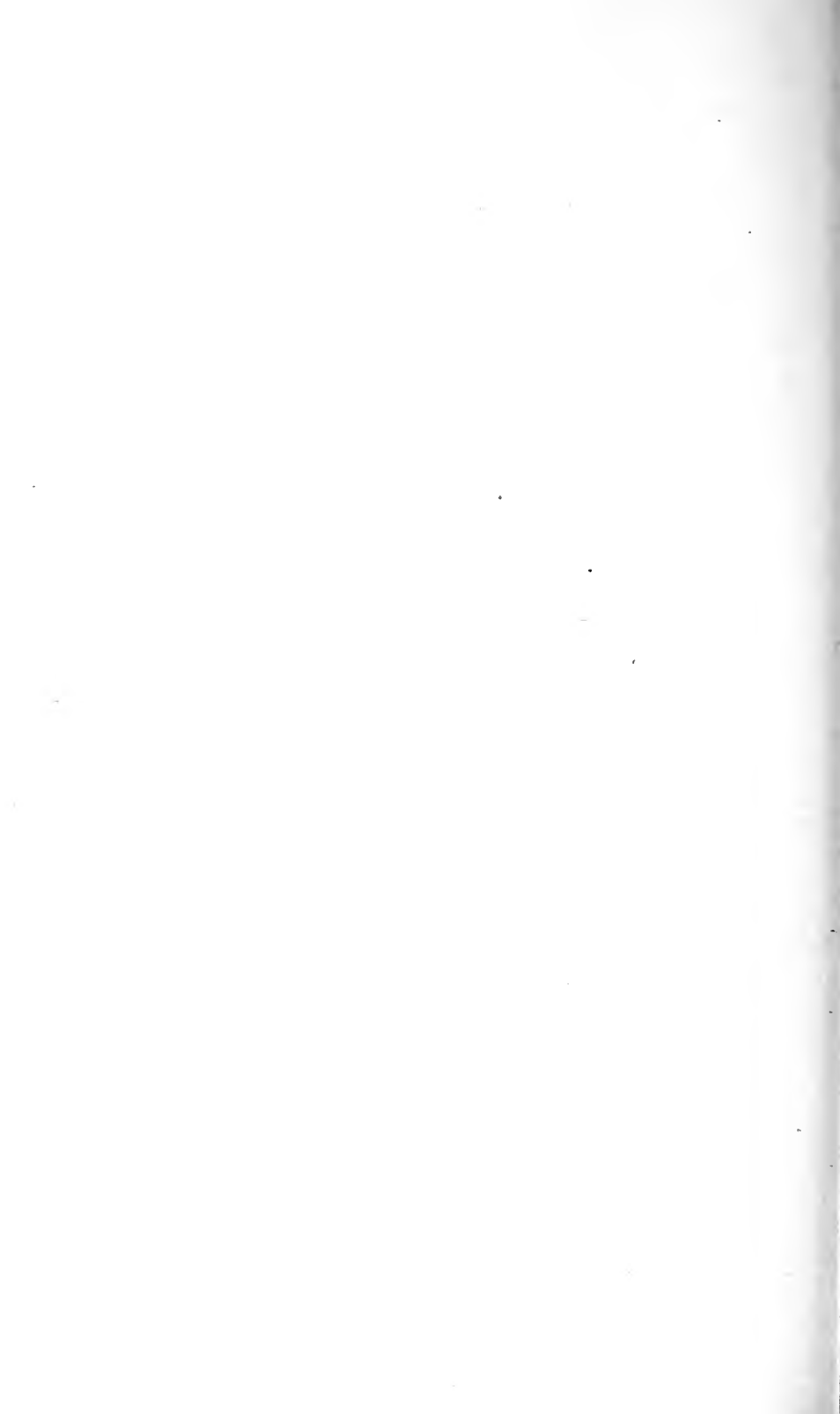
WM. D. MORRISON,

821 First National Bank Building,
San Diego 1, California,

Counsel for Petitioners.

FILED
JAN 20 1949

PAUL R. O'BRIEN,
CLERK



**United States
Court of Appeals**

For the Ninth Circuit

WALTER TREPTE and MARGARET TREPTE,
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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH DISTRICT

No. 12078

WALTER TREPTE and MARGARET TREPTE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE
Respondent.

ON PETITION FOR REVIEW OF THE
DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE PETITIONERS

Opinion of the Tax Court

The memorandum findings of fact and opinion of the Tax Court of the United States (Tr. 28-51) are not reported.

Jurisdiction

This petition for review (Tr. 54-64) involves United States income and victory taxes for the calendar years 1942 and 1943. On August 23, 1946, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiencies in the total amounts as follows:

	Years	Amount
Walter Trepte ----	1942-1943	\$23,183.84 (Tr. 4)
Margaret Trepte----	1942-1943	\$29,480.82 (Tr. 16)

Within ninety days thereafter and on November 18, 1946, the taxpayers filed their petitions with the Tax Court of the United States for a redetermination of those deficiencies under the provisions of Section 272 of the Internal Revenue Code. (Tr. 4-26). The decisions of the Tax Court sustaining the deficiencies were entered May 28, 1948. (Tr. 52, 53). The case is brought to this Court by a petition for review filed August 23, 1948 (Tr. 54-64), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Questions Involved

The questions involved are:

Whether the petitioners are entitled to have their individual Income and Victory Taxes computed for the years 1942 and 1943 as co-partners of the Trepte Construction Co., pursuant to the Articles of Co-partnership dated January 1, 1942, which come within the provisions of Sections 181, 182, 183, 187, and 3797 of the Internal Revenue Code, and Sections 29.181-1, 29.182-1, 29.183-1, and 29.187-1 of the United States Treasury Department Regulations 111; and

Whether the assignment made by Walter Trepte of the community property consisting of assets, property, business, and earnings in and to the Golden & Trepte Construction Co. is a part of the operations of the Trepte Construction Co.

The petitioners contend that the Articles of Co-partnership of the Trepte Construction Co. entered into as of the first day of January 1942 by and between Walter Trepte and Margaret Trepte, husband and wife, and their two sons, Walter B. Trepte and Albert Eugene Trepte, was a bona fide co-partnership for all purposes, including tax purposes, and that all things necessary and

requisite were done pursuant to the provisions of said Agreement of Co-partnership dated January 1, 1942, to come within the provisions of the Internal Revenue Code Supra and that their individual Income Tax returns should be computed according to the UNITED STATES PARTNERSHIP RETURNS OF INCOME filed for the years 1942 and 1943.

The petitioners further contend that Walter Trepte's interest in the Golden & Trepte Construction Company was community property of Walter Trepte and his wife, Margaret Trepte, and that under the provisions of the Articles of Co-partnership dated January 1, 1942, any income from the Golden & Trepte Construction Company was definitely a source of income to the Trepte Construction Co. and that such income reported in the UNITED STATES PARTNERSHIP RETURN OF INCOME was income of the Trepte Construction Co.

The Tax Court of the United States denied the petitioners' contention and held that the Articles of Co-partnership dated January 1, 1942 (Exhibit 1) were ineffective for income tax purposes and found deficiencies in taxes against Walter Trepte and Margaret Trepte, and in view of the conclusion, made no determination as to the assignment of the interest of Walter Trepte in and to the Golden & Trepte Construction Company to the Trepte Construction Co., Co-partnership, pursuant to agreement dated January 1, 1942 (Exhibit 1).

Code and Regulations

The code and regulations involved in this case are found in the Appendix, *infra*.

Statement

Opening statements were made on behalf of petitioners and on behalf of respondent, after which the

witnesses, at the request of respondent's counsel, were excluded from the room while not testifying.

By STIPULATION OF FACTS by the parties, Exhibits 1, 2-A, 3-B, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17-C, 18-D, 19-E, 20-F, and 21 were introduced and received in evidence; respondent's Exhibits G, H, I, J, K, and L were also introduced and received in evidence.

Synopsis of Exhibits

Exhibit 1: The ARTICLES OF CO-PARTNERSHIP, dated January 1, 1942, between Walter Trepte, Margaret Trepte, Walter B. Trepte and Albert Eugene Trepte, who thereby agreed to become partners with 26% interest in each of Walter Trepte and Margaret Trepte and 24% interest in each of Walter B. Trepte and Albert Eugene Trepte.

Walter Trepte conveyed to the partnership all of his office equipment, planing mill equipment, trucks, machinery, cash in bank, accounts receivable, Naval Air Station job equity, being an equity in the partnership assets of Golden & Trepte Construction Company, and all other personal property used by him in his business, as well as all good will of the business, subject to all liabilities as of January 1, 1942, as appeared on his books, condensed as follows:

Cash, Accounts Receivable; Work in Progress; Building Material; and Fixed Equipment less depreciation	\$89,734.05
Naval Air Station job equity	88,458.88
Total Assets	\$178,192.93
Less: Accounts and Notes Payable and Reserve	53,438.04
	<hr/> \$124,754.89 <hr/>

These assets were the community property of Walter Trepte and Margaret Trepte and were thereby converted into separate property.

Walter B. Trepte and Albert Eugene Trepte each gave to Walter Trepte and Margaret Trepte his note dated January 1, 1942, for \$29,941.17, with interest at 3% per annum, for his 24% interest in the net assets of \$124,754.89, all distribution of proceeds to be applied on the balance of the notes unpaid before distribution to them individually.

Joint Exhibit 2-A: The United States Partnership Return of Income, Form 1065, for the calendar year 1942, Trepte Construction Co., shows ordinary net income of \$176,415.67 and capital gains of \$1,992.42, and the partners' share of income as follows:

Name of each partner	Ordinary net income	Net long-term gain
Walter Trepte	\$ 60,822.35	\$ 686.93
Margaret Trepte	57,054.46	644.37
Walter B. Trepte	29,529.06	333.49
Albert E. Trepte	29,009.80	327.63
	<u>\$176,415.67</u>	<u>\$1,992.42</u>

Joint Exhibit 3-B: The United States Partnership Return of Income, Form 1065, for the calendar year 1943, Trepte Construction Co., shows ordinary net income of \$118,030.00 and capital gains of \$1,550.01, and the partners' share of income as follows:

Name of each partner	Ordinary net income	Net long-term gain
Walter Trepte	\$ 44,467.92	\$ 584.05
Margaret Trepte	24,980.04	327.98
Walter B. Trepte	25,523.78	335.11
Albert E. Trepte	23,058.26	302.87
	<u>\$118,030.00</u>	<u>\$1,550.01</u>

Exhibit 4: The August 23, 1946 deficiency letter together with statement to Walter Trepte shows a deficiency of \$23,183.84.

Exhibit 5: The August 23, 1946, deficiency letter, together with statement to Mrs. Margaret Trepte shows a deficiency of \$29,480.82.

Exhibit 6: Declaration of Emancipation of Minor executed by Walter Trepte and Margaret Trepte April 18, 1942, emancipated their son Albert Eugene Trepte, from parental control as of January 1, 1942, and granted to him the right to control and receive his own earnings and to have all the rights of an adult person.

Exhibit 7: Declaration by Albert Eugene Trepte dated April 22, 1947, to the Trepte Construction Co. declared that he became twenty-one years of age on September 8, 1946, and that he thereby ratified and confirmed his acts as a minor in executing the Articles of Co-partnership as of January 1, 1942, and entering in the business of the partnership.

Exhibit 8: The promissory note of Albert Eugene Trepte dated January 1, 1942, payable to Walter Trepte and Margaret Trepte for \$29,941.17, which shows the various payments endorsed thereon, and fully paid with interest by December 29, 1945.

Exhibit 9: The promissory note of Walter B. Trepte dated January 1, 1942, payable to Walter Trepte and Margaret Trepte for \$29,941.17, shows the various payments endorsed thereon, and fully paid with interest by December 29, 1945.

Exhibit 10: Payroll records of payments to Walter B. Trepte on the payroll sheets of Walter Trepte, Builder, for the weeks or periods for 1935 and 1936.

Exhibit 11: The employees' account records (Compensation Record) of Walter Trepte, Builder, shows em-

ployee Walter B. Trepte—record of employment for each of the pay periods for the years 1937, 1938, 1939, 1940 and 1941.

Exhibit 12: Employees' account record (Compensation Record) of Walter Trepte, Builder, shows employee Albert Eugene Trepte—record of employment for the years 1941 and 1942.

Exhibit 13: Ledger sheets of the Trepte Construction Co. books of account, account No. 293, "Walter B. Trepte—Withdrawals" for the period beginning in 1942 and ended September 26, 1947, shows the details of the withdrawals made by Walter B. Trepte for the payment of the note and interest for the purchase of his 24% share in the Trepte Construction Co., Collector of Internal Revenue for U. S. Individual Income Taxes, Franchise Tax Commissioner for California Individual Income Taxes and other personal expenditures. A summary of the said account is as follows:

Errata Page 7 Trepte vs. Commissioner, Brief for the Petitioners.

YEAR	NOTE AND INTEREST	COLLECTOR OF INTERNAL REVENUE	FRANCHISE TAX COMMISSIONER	OTHER PERSONAL EXPENDITURES	TOTAL
1942				\$ 530.97	\$ 530.97
1943	\$11,554.74	\$14,036.58	\$1,164.58	2,651.15	29,407.05
1944	10,529.78	6,682.24	446.88	4,984.81	22,643.71
1945	10,463.27	1,740.59	104.38	2,964.41	15,272.65
1946		24,827.76	638.46	3,697.78	29,164.00
To Sept. 26, 1947		6,727.80	648.21	1,745.29	9,121.30
Total	\$32,547.79	\$54,014.97	\$3,002.51	\$16,574.41	\$106,139.68

Exhibit 14: Ledger sheets of the Trepte Construction Co. books of account, account No. 294, "Albert Eugene Trepte—Withdrawals" for the period beginning in 1942 and ended September 3, 1947 shows the details of the withdrawals made by Albert Eugene Trepte for the payment of the note and interest for the purchase of his 24% share in the Trepte Construction Co., Collector of Internal Revenue for U. S. Individual Income Taxes, Franchise Tax Commissioner for California Individual Income Taxes and other personal expenditures. A summary of the said account is as follows:

YEAR	NOTE AND INTEREST	COLLECTOR OF INTERNAL REVENUE	FRANCHISE TAX COMMISSIONER	OTHER PERSONAL EXPENDITURES	TOTAL
1942					
1943	\$11,554.74	\$12,413.21	\$ 987.11	\$ 755.00	\$25,710.06
1944	10,529.78	5,302.29	346.76	467.88	16,646.71
1945	10,463.27	52.23	55.65		10,571.15
1946		20,110.97	428.77	686.23	21,225.97
To Sept. 3, 1947		4,800.55	417.13	794.80	6,012.48
Total	<u>\$32,547.79</u>	<u>\$42,679.25</u>	<u>\$2,235.42</u>	<u>\$2,703.91</u>	<u>\$80,166.37</u>

Exhibit 15: Ledger sheets of the Trepte Construction Co. books of account, account No. 283, "Walter B. Trepte, Capital," shows his 24% interest in the partnership at the

outset and his accumulated capital from the income after withdrawals, the explanation of which is as follows:

24% share in partnership (Trepte Construction Co.) acquired by purchase January 1, 1942..... \$29,941.17

December 31, 1942 Partner's share of income:

Ordinary net income..... \$28,998.09

Ordinary net income—salary
adjustment 530.97

Net long-term capital gain 666.98

Total \$30,196.04

Less: Withdrawals 530.97

Balance added to capital.... 29,665.07

Capital—December 31, 1942..... \$59,606.24

December 31, 1943 Partner's share of income:

Ordinary net income..... \$22,993.78

Ordinary net income—salary
adjustment 2,530.00

Net long-term capital gain 670.22

Total 26,194.00

Less: Withdrawals 29,407.05

Balance, decrease of capital -(3,213.05)

Capital—December 31, 1943..... \$56,393.19

December 31, 1944 Partner's share of income:

Ordinary net income..... \$ 7,386.44

Ordinary net income—salary
adjustment 4,800.00

Net long-term capital gain 950.12

Total \$13,136.56

Less: Withdrawals 22,643.71

December 31, 1945 Partner's share of income:

Ordinary net income\$25,226.09

Ordinary net income—salary

adjustment 4,800.00

Net long-term capital gain 163.20

Total\$30,189.29

Less: Withdrawals 15,272.65

Balance added to capital 14,916.64

Capital—December 31, 1945.....\$61,802.68

December 31, 1946 Partner's share of income:

Ordinary net income.....\$24,844.45

Ordinary net income—salary

adjustment 4,800.00

Net long-term capital gain 222.90

Total\$29,867.35

Less: Withdrawals 29,164.00

Balance added to capital..... 703.35

Capital—December 31, 1946.....\$62,506.03

Summary

24% share in partnership acquired by pur-

chase January 1, 1942.....\$29,941.17

PARTNER'S SHARE			
YEAR	OF INCOME	WITHDRAWALS	DIFFERENCE
1942	\$30,196.04	\$ 530.97	\$29,665.07
1943	26,194.00	29,407.05	-(3,213.05)
1944	13,136.56	22,643.71	-(9,507.15)
1945	30,189.29	15,272.65	14,916.64
1946	29,867.35	29,164.00	703.35
	<u>\$129,583.24</u>	<u>\$97,018.38</u>	<u>\$32,564.86</u>

Net addition to capital account of

Walter B. Trepte..... 32,564.86
December 31, 1946—

Walter B. Trepte—Capital.....\$62,506.03

Exhibit 16: Ledger sheets of the Trepte Construction Co. books of account, account No. 284, "Albert Eugene Trepte, Capital," shows his 24% interest in the partnership at the outset and his accumulated capital from the income after withdrawals, the explanation of which is as follows:

24% share in partnership (Trepte Construction Co.) acquired by purchase January 1, 1942 \$29,941.17

December 31, 1942 Partner's share of income:

Ordinary net income.....\$29,009.80

Net long-term capital gain ... 655.27

Total\$29,665.07

Less: Withdrawals None

Balance added to capital... 29,665.07

Capital—December 31, 1942..... \$59,606.24

December 31, 1943 Partner's share of income:

Ordinary net income.....\$23,058.26

Net long-term capital gain ... 605.74

Total\$23,664.00

Less: Withdrawals 25,710.06

Balance, decrease of capital -(2,046.06)

Capital—December 31, 1943 \$57,560.18

December 31, 1944 Partner's share of income:

Ordinary net income.....\$ 7,733.02

Net long-term capital gain..... 603.54

Total\$ 8,336.56

Less: Withdrawals 16,646.71

Balance, decrease of capital -(8,310.15)

Capital—December 31, 1944..... \$49,250.03

December 31, 1945 Partner's share of income:

Ordinary net income.....\$25,226.08

Net long-term capital gain.. 163.20

Total\$25,389.28

Less: Withdrawals 10,571.15

Balance added to capital.. 14,818.13

Capital—December 31, 1945..... \$64,068.16

December 31, 1946 Partner's share of income:

Ordinary net income.....\$24,844.45

Net long-term capital gain.. 222.90

Total\$25,067.35

Less: Withdrawals 21,225.97

Balance added to capital.... 3,841.38

Capital—December 31, 1946 67,909.54

Summary

24% share in partnership acquired by purchase January 1, 1942.....

\$29,941.17

YEAR	PARTNER'S SHARE OF INCOME	WITHDRAWALS	DIFFERENCE
1942	\$29,665.07	None	\$29,665.07
1943	23,664.00	\$25,710.06	-(2,046.06)
1944	8,336.56	16,646.71	-(8,310.15)
1945	25,389.28	10,571.15	14,818.13
1946	25,067.35	21,225.97	3,841.38
Total	\$112,122.26	\$74,153.89	\$37,968.37

Net addition to capital account of

Albert E. Trepte..... 37,968.37

December 31, 1946—

Albert E. Trepte—Capital.....\$67,909.54

Joint Exhibit 17-C: 1942 United States Individual Income Tax Return of Walter Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$60,822.35 and from net gain from sale of capital assets \$686.93.

Joint Exhibit 18-D: 1943 United States Individual Income Tax Return of Walter Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$44,467.92, and from net gain from sale of capital assets \$584.05.

Joint Exhibit 19-E: 1942 United States Individual Income Tax Return of Margaret Trepte shows the amount she received from the Trepte Construction Co. partnership as ordinary net income \$57,054.46, and from net gain from sale of capital assets \$644.37.

Joint Exhibit 20-F: 1943 United States Individual Income Tax Return of Margaret Trepte shows the amount she received from the Trepte Construction Co. partnership as ordinary net income \$24,980.04, and from net gain from sale of capital assets \$327.98.

Exhibit 21: Certificate of Fictitious Name of the Trepte Construction Co. shows the owners as the four partners named in the Agreement of Co-partnership dated January 1, 1942, which was recorded May 12, 1942, in the office of the County Clerk of the County of San Diego, also Publication was made and Affidavit of Publication was filed June 12, 1942, with the County Clerk of the County of San Diego as provided by the Civil Code of California, Section 2466.

Respondent's Exhibit G: 1942 United States Individual Income Tax Return of Walter B. Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$29,529.06, and from net gain from sale of capital assets \$333.49.

Respondent's Exhibit H: 1943 United States Individual Income Tax Return of Walter B. Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$25,523.78, and from net gain from sale of capital assets \$335.11.

Respondent's Exhibit I: 1942 United States Individual Income Tax Return of Albert Eugene Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$29,009.80, and from net gain from sale of capital assets \$327.63.

Respondent's Exhibit J: 1943 United States Individual Income Tax Return of Albert Eugene Trepte shows the amount he received from the Trepte Construction Co. partnership as ordinary net income \$23,058.26, and from net gain from sale of capital assets \$302.87.

Respondent's Exhibit K: Navy Department Bureau of Yards and Docks, Contract NOY-4205, dated July 6, 1940, (cost-plus-a-fixed-fee) with M. H. Golden and Walter Trepte, called the Contractors. Excerpts from the said contract are as follows:

"TIME OF COMPLETION. ARTICLE 6.—The Contractors agree to proceed immediately with the organization of office and field forces to be engaged upon the work under this contract and to direct their efforts toward early purchases and transportation of materials and the initiation of actual construction work on the site; and to concentrate upon rapid progress and the completion of the entire work at the earliest possible date.

"PLANT AND EQUIPMENT. ARTICLE 7.—The Contractors shall provide all plant and equipment required for the accomplishment of the work under this contract, * * *

"SERVICES AND LABOR. ARTICLE 8.—(a) All services and labor, including personal services of every character, * * *

"MATERIALS. ARTICLE 9.—(a) All materials required for the accomplishment of the work under this contract shall be provided by the Contractors, including materials, articles, and supplies required for temporary use and such as may be consumed in use. * * *

"TERMINATION OF CONTRACT. ARTICLE 13.—(a) Should the Contractors at any time refuse, neglect, or fail to prosecute the work with promptness and diligence, * * *

"RECORDS AND ACCOUNTS. ARTICLE 23.—The Contractors agree to keep accurate records and books of accounts, on a job-order basis, * * *

"PAYMENTS TO THE CONTRACTORS. ARTICLE 26.—The Government agrees that the Contractors may submit at intervals of not less than seven calendar days payment requisitions accompanied by duly certified and approved payrolls, invoices, bills or other substantiating documents, * * *"

Respondent's Exhibit L: Contract on a cost plus a fixed fee, dated June 30, 1942, between Rohr Aircraft Corporation, a California corporation, acting for and on behalf of the Defense Plant Corporation, and Walter Trepte and M. H. Golden individually, doing business as the Golden & Trepte Construction Company, hereinafter called "Engineer-Contractor." The total estimated cost of the contract was \$644,339.00, exclusive of Engineer-Contractor's fee. It was estimated that the work as provided for in the contract would be ready

for utilization by the owner on or before October 15, 1942.

Statement from Oral Evidence

Walter B. Trepte, the elder son of the petitioners, testified that he was twenty-nine years of age and had lived in San Diego, California all of his life and attended grammar school, high school and college there. (Tr. 75);

That he worked for his father in the construction business during the summer of 1935, two months of 1936, during the fall of 1938, all of 1939, and July and August of the year 1940, and to the end of the year 1940 for Golden & Trepte Construction Company, during the year 1941 he worked for Golden & Trepte Construction Company in the timekeeping department where he was in charge of personnel and timekeeping, did some of the bookkeeping and took care of certain security work that the Navy requested and did all of the hiring and firing of the men. (Tr. 76, 77).

As of January 1, 1942, Walter B. Trepte became a co-partner of the Trepte Construction Co. pursuant to Articles of Co-partnership Exhibit 1. The formation of the Co-partnership was discussed with his father and mother, and brother Gene (Albert Eugene Trepte), during the fall of 1941. The object of the formation of the Co-partnership was to carry on the business of the Trepte Construction Co. in the event that his father should meet with a tragedy. During the fall of 1941, his father was making many hazardous trips by airplane, in connection with his construction work. (Tr. 77, 78, 91-93, 154, 155).

Although Walter B. Trepte worked on jobs of the Trepte Construction Co., the Rohr Aircraft Corporation, and the Golden & Trepte Construction Company, all of his services were for and in behalf of the Trepte

Construction Co. and any salary or remuneration he may have received on the various jobs was given consideration at the time an adjustment of his co-partnership remuneration was made at the end of each year, at which time he received \$4800.00 as remuneration for his services from his co-partnership, the Trepte Construction Co. (Tr. 78-80).

A portion of Walter B. Trepte's 24% share in the net income of the Trepte Construction Co. partnership was withdrawn for his personal use, said withdrawals consisted of numerous items which he identified, such as the payments and interest on his note (Exhibit 9) dated January 1, 1942, payable to Walter Trepte and Margaret Trepte for his purchase of a 24% interest in and to the partnership, Collector of Internal Revenue for his United States Individual Income Taxes, Franchise Tax Commissioner for his California Individual Income Taxes, and other personal expenditures. Many of the checks issued for the said withdrawals were signed by the witness and all of them were drawn on the Trepte Construction Co. bank account (See summary of Exhibit 13). (Tr. 80-83, 87, 89-91, 98-100).

During the fall of 1941 when the discussions took place regarding the formation of the co-partnership, the question of tax reduction or avoidance was never brought up. (Tr. 85, 91-93).

Walter B. Trepte signed checks against the Trepte Construction Co. partnership account, and prior to that time from 1937 on, he was authorized to sign checks for and in behalf of his father, Walter Trepte, Builder, and he hired and fired employees of the Golden & Trepte Construction Company from May of 1941 and also of the Co-partnership of which he was a partner, Trepte Construction Co. These constituted valuable and vital

services to the Trepte Construction Co. (Tr. 100, 101, 163).

ALBERT EUGENE TREPTE, second son of the petitioners, stated that he was twenty-two years old, that he was twenty-one on September 8, 1946; he worked for his father in the construction business in the summer of 1941, in the summer of 1942, he delivered and rustled material, which gave him a chance to get around the jobs and understand what was going on. He also went with his father on estimating jobs and discussed them with him. In 1943 he went to summer school. (Tr. 103, 105).

He was in the service from February 28, 1944 until June 7, 1946. He served in the Western Sea Frontier, Southern Sector, for the Navy aboard a 250 foot schooner patrolling the Guadalupe Patrol six hundred miles off San Diego; he held the rate at first, of First Seaman; having had experience in sailing, he was put in the capacity of Leading Seaman handling sails and docking the ship. He was schooled in the Quartermaster's Department, and as Sailing Master he directed men and officers. (Tr. 104, 109, 110).

Having worked in the construction business with his father, Walter Trepte, it was his desire to learn the practical end of the construction business, and he decided to attend California State Polytechnic College at San Luis Obispo, for a two years course, and was taking architectural engineering, which he finished in the spring of 1948. His father had similar schooling. (Tr. 106).

Upon reaching the age of majority, Albert Eugene Trepte ratified the partnership agreement which was entered into when he was a minor. (Exhibit 7). He had discussed the partnership agreement with his father before January 1, 1942, had given his note (Exhibit 8)

for the purchase price of his share of the partnership and that the note was fully paid in 1945. (Tr. 106, 107).

He identified various items of expenditures which were charged to his withdrawal account, such as the payments and interest on his note (Exhibit 8) dated January 1, 1942, payable to Walter Trepte and Margaret Trepte for his purchase of a 24% interest in and to the partnership, Collector of Internal Revenue for his United States Individual Income Taxes, Franchise Tax Commissioner for his California Individual Income Taxes, and other personal expenditures (See summary of Exhibit 14). (Tr. 107, 108, 112).

His source of income since 1942 was from the Trepte Construction Co. and the Navy. (Tr. 113).

MARGARET TREPTE, one of the petitioners, wife of Walter Trepte, and also one of the partners of the Trepte Construction Co., testified that she married Walter Trepte in 1916 when he was working for his father as an employee in the construction business; he did not own anything at the time they were married; they have lived together ever since as husband and wife and whatever he earned since their marriage was community property. (Tr. 115).

She remembered the discussions in regard to the partnership and taking the boys into it; it was talked about for quite a while in 1940 and 1941, as the boys grew up; she executed the 1942 partnership agreement as one of the partners and knew that at that time she was giving up nearly one-half of her community property; she favored the partnership because her husband was flying a good deal and if anything should happen, there would be somebody to carry on and she wanted it that way. The boys had expressed a preference for that kind of work. (Tr. 115, 116).

In discussing the formation of the partnership there was no discussion about reducing taxes. There was mention of the precedent of Mr. Trepte and his father and their partnership. (Tr. 116).

Before the partnership agreement of January 1, 1942 was executed, she said she read it, knew what it contained, signed, it, knew the provision in regard to any of the partners' selling his interest; that the dealings under the partnership were controlled by the majority holding of the partners and that other than her husband, the partners were her two sons. (Tr. 117).

Eugene talked and planned on going into the construction business with his father, all of his life. He would work for his father in the summertime, and when he was at home on vacation, he would go down to the office; when at home, he looked over the books and would take trips with his father around the jobs. (Tr. 117, 118).

The petitioners were in agreement about the boys going into the co-partnership. (Tr. 121).

WALTER TREPTE stated that he was fifty-four years old, a general contractor, engaged in the business since 1917 and before that in various occupations of the contracting industry; worked for his father, Morris Trepte, before 1917 in San Diego and in that year became a partner with his father, giving him a note for an interest in the partnership, which note was paid out of earnings. (Tr. 121, 122).

His father had previously had a partner by the name of Ed Rambo and the witness bought out his interest. Before becoming such partner he had had schooling of two years of structural design in the California School of Mechanical Arts at San Francisco, from 1910 to 1912. From 1912 to 1917 he worked with his father.

The partnership with his father continued until 1928 when the witness bought out the father, paying cash. From 1928 to 1942 there was no one associated with him in his business, which consists of what is known as commercial construction and some engineering construction. His particular architectural and engineering education gave him definite assistance in that work, enabling him to grasp the fundamentals much faster than if he had not had the training, and he was able to do the engineering work himself on his jobs, whereas others would have had to employ architects. (Tr. 122, 123).

Walter Trepte hoped that his sons would join him in the business and influenced them all he could, particularly in the schooling for Gene (Albert Eugene Trepte) in the Polytechnic school, which was discussed with Gene and which the witness had investigated and recommended. (Tr. 123, 124).

He formed the Trepte Construction Company because of the flying that he had to do to get to offshore Navy jobs and because of the business background. He had gone in with his father and thought it was a good thing for his sons to do likewise. On one of the earlier trips to San Clemente Island with Mr. Golden they had a near crash in landing in a fog and discussed the question of what would become of that particular fixed contract with the Navy in case of the death of one or both of them. Witness told Mr. Golden that he had been considering having the boys go into partnership with him and thought that he should form a partnership as soon as he could to carry on the business if anything happened to him. The same line of thought was suggested to him by a government man; Officer Montgomery or Henry B. Smith, while riding in a plane to San Clemente Island, agreed that it would be a very involved matter in case

of accident and if anything happened to the witness. Witness went to San Clemente Island about once a week travelling by air north to Oceanside to a controlling station, then westerly to San Clemente Island. The time of this discussion of the forming of a partnership must have been in the summer of 1941 when they started the San Clemente Island job NOY-4205, Bureau of Public Works, U.S.N. (Tr. 124, 125, 154).

The original contract was for \$2,700,000.00, mostly on North Island in San Diego Bay, which contract had to be completed in about a year's time. The contract was then extended to include Brown Field on the lower end of San Diego Bay, Otay Mesa Airfield facilities, Kearney Mesa Airfield facilities and San Clemente Airfield facilities. The compensation for the work under this contract was paid on a fixed fee basis determined by the officer in charge. The original fee was in the neighborhood of 3 %, paid from the Bureau of Public Works in Washington or the Bureau of Yards and Docks in Washington, he didn't know which; payments were made in installments; the final payment was not determined until the termination of the contract. Payments for labor and material were originally made monthly, then as the job became larger they were made bi-monthly and finally weekly. In order to obtain payments the paid bills and cancelled checks were sent to the Government. The contract eventually ran into between \$21,000,000.00 and \$22,000,000.00. The fee for the first \$2,000,000.00 job was about 3 %, which was reduced later to whatever the Bureau of Yards and Docks agreed to, becoming smaller and smaller. (Tr. 125-127).

After the talk with Mr. Golden, witness discussed the partnership with his family in the fall of 1941. He explained to the boys the advantage of their being taken in

as partners; he had had that experience himself and he found what a big advantage it was to take over a reputation for ability and integrity that you don't have to sweat for yourself, and the boys were able to see and appreciate it; they were questioned about their wishes, and wanted to go into the partnership, (Tr. 127, 128).

There was no discussion about avoiding or reducing taxes at the time of forming the co-partnership. (Tr. 128).

When the partnership was made, Walter B. Trepte was sufficiently educated in the business to take responsibility. He could take care of the office and accounting, do the hiring and the personnel end of the work. He was assistant manager.

The item "Naval Air Station job equity \$88,458.88" set out under the caption "Assets" in the partnership agreement was working capital and money owed to him for labor and material; none of it was profits on the job. (Tr. 130, 152, 153).

Walter B. Trepte had been working for Walter Trepte off and on since 1935; he was personnel man for the partnership and signed checks. (Tr. 130, 131).

After the partnership was formed, there were adjustments made by the partners as to a drawing account to equalize the different earning capacity of the partners. The amount that Walter B. Trepte drew was around \$4,800.00 or \$5,000.00 a year, and Walter Trepte, the petitioner, drew \$20,000.00 a year, except in 1944 when the business was slow and he drew \$10,000.00. Those salaries mentioned were deducted before figuring the profits to be divided between the partners. After the partnership was formed, the boys had the right to withdraw any partnership funds for their own use and did withdraw. (Tr. 131, 132).

At the time the partnership was formed Albert Eugene Trepte had shown an aptitude for the construction business. He had natural ability to handle men and had an interest in the engineering end of the business. Witness thought he had exceptional ability so far as being able to get business, which is a big factor in the work; when the partnership was formed he had shown definite interest in what jobs were doing, what the costs of the jobs were and always showed an interest in the number of jobs—where they were and how they were progressing. He had gone to the jobs with the witness and on questioning had said that he went there to enlighten himself. He entered into discussions as to the character of the job and how it could be handled. (Tr. 132, 133).

Witness identified his signature and that of his wife to Exhibit 6 (Declaration of Emancipation of Minor) dated April 18, 1942. He stated that he had never collected or used any part of Gene's earnings and never paid any of his expenses or school expense; they were drawn by Gene out of his share of the partnership. (Tr. 133).

The petitioners have a child other than the two boys who are partners—a daughter—who was not considered in talking of the partnership, as they did not feel that she would lend any benefit to the partnership. (Tr. 134).

Other than the Navy Air Station job NOY 4205 there were other government jobs that he was doing between 1940 and the end of the war, among them the fuel depot job at San Diego, the defense plant job at Rohr Aircraft Company in Chula Vista, the sea water tunnel job for the San Diego Gas & Electric Company, which the witness thought the government was backing, and several jobs for Ryan Aeronautical Company; the Navy paid for one of the Ryan jobs and the Defense Plant Corporation for the other. The water tunnel job ran about

\$300,000.00, the Navy Fuel Depot job \$750,000.00, the Rohr Defense Plant job close to \$1,000,000.00, and Ryan close to \$1,000,000.00. The Ryan job was taken under Trepte Construction Company and the Fuel Depot and tunnel and one of the Rohr Aircraft jobs by Golden & Trepte Construction Company. (Tr. 134, 135).

On or about January 1st, 1942, he had around 75 to 100 employees. In the Naval Air Station work the Golden & Trepte Company was employing at the peak 1,500 men. (Tr. 135, 136, 141, 152).

Walter B. Trepte had additional responsibility in connection with the Naval Air Station job. First, he was with the timekeeping department, then assistant personnel man, then equipment manager, toward the end of the contract when they were having hurdles at the job and immediately had to get very large amounts of equipment, particularly rental equipment, he supervised the procurement of the material as a representative. (Tr. 136).

The Trepte Construction Company is still continuing as a going partnership. There were no plans to change it in the future. (Tr. 137).

When asked concerning his employment by and partnership with his father in the previous years, as to what kind of business it was, he replied that it was the same business—construction business; that the father started in San Diego in 1895, doing commercial contracting and engineering contracting; building construction is commercial buildings in particular, building factories and warehouses; engineering contracting is usually road work, bridges or waterfront work; in every case it requires, for the purpose of submitting bids, a knowledge of and skill in engineering and construction engineering and labor, materials and prices. (Tr. 137, 138).

His father's former partner was Edward L. Rambo. Witness bought his interest in 1917, giving his father a note for one-half of the business. Rambo left the business and the witness came in his place. He had been working as Superintendent for his father and Rambo at that time. In 1917 he was twenty-four years of age and had been working for his father since 1915. (Tr. 138, 139).

In 1928 he bought his father's interest in the business for cash. There was a division of property and a cash adjustment; they naturally had accumulated some real estate in the business transactions. The father took the bulk of the real estate and an adjustment was made in cash. (Tr. 140).

Walter B. Trepte purchased additional or new equipment in connection with the NOY 4205 job. (Tr. 143).

Asked if it was not a fact that his son, Walter B. Trepte, had never shown any real interest in the business, at least from its technical aspects and engineering features, he replied, "I would not say that. He certainly shows an interest in the operation of the business. His inclination is toward the accounting and the office end of it and the equipment end of the business." (Tr. 153).

Walter B. Trepte was competent to carry on the contracts in the event of the death of Walter Trepte. (Tr. 156).

Walter B. Trepte had helped prior to January 1, 1942 and also subsequent thereto to assemble data necessary for the preparation and submission to the government, concerns and persons, bids for construction work. (Tr. 156, 157).

The family partnership arrangement originated with discussions of his wife and himself (Walter Trepte) for years previous; he had had the same sort of partnership with his father; his father had been able to build up the

good will and integrity of the business prior to the time Walter Trepte was taken in as a partner and up to the time he bought his father out. Witness stated that he kept the good will and integrity of the business and felt that it should be continued by taking in his sons who were able to become partners. (Tr. 157, 158).

The matter of the partnership had never been discussed with any attorney or any accountant prior to the time that it was decided to go through with the plan. (Tr. 159).

Mr. Stone was consulted the latter part of 1941. Mr. Trepte could not say the exact day the actual document was drawn up, but it was around the first of the year. Walter Trepte told the attorney (Mr. Stone) the substance of the provisions wanted in the agreement. Mr. Stone had been his father's and his attorney prior to 1941, had handled the dissolution of the partnership with his father in 1928, but had nothing to do with the transaction whereby he bought out the interest of Rambo in 1917. There was no attorney then; there were not enough assets to pay for an attorney. (Tr. 159, 160).

It was Walter Trepte's purpose that his wife and two sons should carry on the business if anything happened to him; that his older son was trained and had the ability. (Tr. 161, 162).

The Navy contract on North Island was not made on a bid, but was negotiated between Commandant of the Eleventh Naval District, together with the Public Works Officer, to handle a given amount of construction work at North Island; Trepte & Golden did not apply for the job; the Government applied to them. (Tr. 164, 165).

Walter B. Trepte went out of the state to procure equipment in connection with the North Island job; it was a large procurement of several hundred thousand dol-

lars worth of equipment out of the CCC camps at that time in the state of Arizona. It was a transaction between the navy and the CCC authority. He was picked for that job by the officer in charge and did it satisfactorily. (Tr. 165).

The Court inquired of Walter Trepte what consideration had been given in forming partnership agreement with reference to the escape of taxes, and was informed that the tax angle had not been taken into consideration, that the main thing was to have the boys in the business to carry on in case of his death. (Tr. 166, 167).

Specifications of Errors Relied Upon

(1) The findings of the Tax Court are not supported by the evidence;

(2) The failure to hold that the ARTICLES of CO-PARTNERSHIP of the Trepte Construction Co., dated January 1, 1942, were effective as of said date and constituted a bona fide partnership for tax purposes;

(3) The failure to find that the petitioner, Margaret Trepte, and each of the sons of the said petitioner, Walter B. Trepte and Albert Eugene Trepte, contributed capital to the said co-partnership;

(4) The failure to hold that each of the said sons, Walter B. Trepte and Albert Eugene Trepte, contributed vital services to the co-partnership;

(5) The failure to find that each of the said sons, Walter B. Trepte and Albert Eugene Trepte, had a share in the management and control of the business;

(6) The failure to determine that there was a definite relation between the profits allocated to each partner and the value of the services rendered;

(7) The failure to find that there was no casting about for a legal means of lessening the tax;

(8) The failure to find that the formation of the present co-partnership by and between the members of the Trepte family constituted a bona fide co-partnership for tax and all other purposes of the third generation of the Trepte family who have constantly carried on the integrity and good will of the construction business under the Trepte name;

(9) The failure to find that Walter B. Trepte and Albert Eugene Trepte each had his share of the profits derived from the partnership; each had control of his share of the profits; and each son had the right to withdraw his share of the profits without being hampered by his parents in any way;

(10) The failure to hold that the partnership did all things necessary and requisite to constitute a partnership as provided for by the laws of the State of California, and by the Internal Revenue Code, more specifically Sections 181, 182, 183, 187 and 3797;

(11) The findings of deficiencies for the years 1942 and 1943 in lieu of a determination that there is no income tax due from the petitioners, Walter Trepte and Margaret Trepte, for either of the years in controversy;

(12) The Tax Court of the United States erred in rendering its decisions for respondent. (Tr. 61-63).

Summary of Argument

The ARTICLES OF CO-PARTNERSHIP of the Trepte Construction Co. were made and entered into in good faith as of the first day of January, 1942 by and between Walter Trepte and Margaret Trepte, the petitioners herein, husband and wife, and their two sons, Walter B. Trepte and Albert Eugene Trepte, to conduct, carry on and do business as the Trepte Construction Co., pursuant to the ARTICLES OF CO-PARTNERSHIP,

and it was the purpose and intent of all of the parties to form an actual, real, valid, and bona fide co-partnership for all purposes.

All of the code provisions of the State of California were complied with in the formation of a real, actual, valid, and bona fide co-partnership.

The formation of the Trepte Construction Co., Co-partnership by and between the members of the Walter Trepte family, constitutes the third generation who have consistently conducted and carried on the integrity and good will of the construction business under the TREPTE name for a period of approximately a half of a century.

Each of the sons, Walter B. Trepte and Albert Eugene Trepte, rendered vital and valuable services to the co-partnership; each had his duties to perform in connection with the co-partnership and performed them in an efficient and satisfactory manner and each participated in the management and control of the business.

Shortly before the formation of the Trepte Construction Co., the business of Walter Trepte had extended far beyond any anticipated growth. It was, therefore, necessary for him to have others associated with him, in whom he could place confidence and trust to aid and assist him in carrying on and conducting the business. Naturally, his two sons were the logical persons.

Margaret Trepte's contribution to the co-partnership capital was from her community property. Walter B. Trepte and Albert Eugene Trepte each obtained, by purchase, his co-partnership interest in the Trepte Construction Co. by signing a binding obligation in the form of a note (Exhibits 8 and 9) to obtain his interest and the obligation of each was fully discharged by December 29, 1945. There was no element of gift to the sons.

There was a determination of the value of the services rendered by each of the co-partners before the profits were allocated according to the ownership in the Trepte Construction Co. The equalization was made to Walter Trepte, and Walter B. Trepte, according to the value of the services performed for and in behalf of the co-partnership.

The formation of the Trepte Construction Co. Co-partnership was not originated as a means of tax reduction, avoidance, or making a division of the family income, as the tax angles were not discussed prior to the time that the co-partnership became an actual entity.

Neither, Walter Trepte, father, nor Margaret Trepte, mother, attempted to deprive either of their sons of his share of the profits. Each son had the independent retention of his share of the profits.

There was no gradual change from Walter Trepte, Builder, into the co-partnership as was mentioned in the opinion of the Tax Court (Tr. 49). The change was effective as of the formation of the co-partnership January 1, 1942.

At the time of the formation of the co-partnership, TREPTE CONSTRUCTION CO., Walter Trepte duly assigned to the said co-partnership all of the community property assets, property and business subject to the liabilities which he had used to conduct and carry on the business and operations under the name of Walter Trepte, Builder (Exhibit 1).

Walter Trepte duly assigned to the said co-partnership all of his interest in and to the property, business and earnings of the Golden & Trepte Construction Company which was a one-half interest (Exhibit 1).

Argument

PETITIONERS ARE MEMBERS OF THE TREPTE CONSTRUCTION CO., A CO-PARTNERSHIP, AND ARE ENTITLED TO HAVE THEIR INDIVIDUAL INCOME TAXES COMPUTED ON THE BASIS OF THEIR SHARE OF THE INCOME OF THE CO-PARTNERSHIP AS PROVIDED FOR IN SECTIONS 181, 182, 183, 187, and 3797 OF THE INTERNAL REVENUE CODE.

Such Sections of the Internal Revenue Code (Appendix, *infra*) set forth a procedure by which it is submitted that the amount of income of the respective petitioners should be determined so far as the income from the Trepte Construction Co., a co-partnership, is concerned.

The Tax Court of the United States in the first sentence of its opinion of this case states:

“Factually, the first issue in this case follows the now familiar pattern of family partnerships, and is in many respects similar to *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293.”

Those two cases are readily distinguishable from the case now before this Court. The question in those cases involved husband and wife partnerships and in both instances not in a community property state. Whereas, the question before this honorable Court involves husband and wife in a community property state, and their two sons, wherein the facts and circumstances are entirely different.

It is contended that the Trepte Construction Co. co-partnership comes within the following definition of partnership:

"*Commissioner vs. Tower*, 327 U. S. 280 at 286, 90 Law Ed. 670 at 675, defines a partnership as follows: 'A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. (Citing *Ward vs. Thompson*, 22 How (US) 330, 333, 334, 16 L. Ed 249-251; *Meehan v. Valentine*, 145 US 611, 618, 36 L. Ed 835, 839, 12 S. Ct. 972.)'

B. W. Graham, 8 BTA 1081, the Board quoted from Chancellor Kent the following definition: 'A contract of two or more competent persons to place their money, assets, labor and skill or some or all of them in lawful commerce or business, and to divide the profits and bear the losses in certain proportions.'"

The Articles of Co-partnership of the Trepte Construction Co. (Exhibit 1) were made and entered into in good faith as of the first day of January, 1942, by and between Walter Trepte and Margaret Trepte, husband and wife, and their two sons, Walter B. Trepte and Albert Eugene Trepte to conduct and carry on the business of the Trepte Construction Co. which had been formerly carried on under the name and style of Walter Trepte, Builder, doing commercial construction, engineering construction, road work, and bridge construction. (Tr. 123). It was the purpose and intent of all of the parties at the time the co-partnership was entered into to form an actual, real, valid, and bona fide co-partnership for all purposes. Only those members of the family which it was considered would be beneficial to the operation and conduct of the business were taken into the co-partnership,

and for that reason the petitioners' daughter was excluded as a member (Tr. 134).

Prior to January 1, 1942, the sons were merely employees of their father, in his business as a contractor and builder, their services could have been terminated at any time, they had no investment in the business and were not liable for any losses sustained by the business. After January 1, 1942, this situation was entirely changed, the sons were co-partners with their father and mother, they had signed notes (Exhibits 8 and 9) which obligated them to a definite liability, they had agreed to share in both the profits and losses of the business, and the success or failure of the business fell upon them equally with the other co-partners. It was through the skill of the father, Walter Trepte, and his two sons, Walter B. Trepte and Albert Eugene Trepte, whom he had educated and trained in the business from the time they were small boys until they came into the business with him, that brought about the success of the Trepte Construction Co.

All things necessary and requisite were done pursuant to the provisions of the Civil Code 2466 of the State of California to qualify as a real, actual, legal, valid, and bona fide partnership in the County of San Diego, State of California, where the principal office of the Company is located (Exhibit 21).

The good will and integrity of the name TREPTE in the contracting and building trade has continued for nearly half a century, Walter Trepte's father started in business in San Diego in 1895 (Tr. 137). Through the period of years the Trepte family has done several contracting jobs for the same corporations or persons, all of which shows reliance and confidence in a job satisfactorily accomplished or done in a proper and workmanlike manner (Tr. 158).

Walter Trepte had a similar partnership with his father who was able to build up good will and integrity and when Walter Trepte succeeded his father in the business, he was able to retain it, and he felt that the same good will and integrity could be continued by taking into the co-partnership his sons. (Tr. 158).

In the case of *W. O. Culbertson, Sr. and Gladys Culbertson v. Commissioner of Internal Revenue* 168 F (2d) 979 the Court said:

“Neither the Constitution, the statutes, nor public policy requires that partnerships between fathers and sons be outlawed or discouraged. The desire of a father in any age or clime, with a business that he cherishes and a son that he loves, to have such son with him in his business and to carry it on when he no longer can, was not rendered an anathema by the *LUSTHAUS* and *TOWER* cases, and aberrations from the salutary rules announced in those cases should not now do so.”

To say that Walter B. Trepte and Albert Eugene Trepte are co-partners with their father and mother for all purposes except for Federal tax purposes would preclude them from obtaining the benefit of the fine reputation and good will of the family tradition of contractors and builders, which was accomplished by their father and grandfather. Under such circumstances they would be required to start anew—all of which is against good sound economic principles.

The services of the two sons were valuable and vital to the operations of the co-partnership:

Walter B. Trepte had much to do with the finances of the co-partnership and as has been shown by the transcript of record one of the contracts, NOY 4205 dated July 6, 1940 (Exhibit K), before it was completed, ran

into figures of approximately \$22,000,000.00. He had charge of equipment (Tr. 143), procured materials, hired and fired workmen, determined procedure in connection with the co-partnership that came under his observation, was looked upon by his father as the one upon whom he could rely for assistance, he was placed in positions of confidence and trust, all of which are a vital and valuable element in connection with the conduct and carrying on of a business the magnitude of the Trepte Construction Co. He was trained to carry on the business if anything should happen to his father (Tr. 162).

Albert Eugene Trepte worked on several of the jobs of the co-partnership. He delivered, procured and rustled material, went with his father on various jobs and discussed the jobs with his father. He had natural ability to handle men, an interest in engineering and being able to obtain business, which is a vital factor in the contracting business (Tr. 132). His education has been channeled from early childhood to engage in the construction business: about the middle of the year 1948, he completed a two year course in architectural engineering in California State Polytechnic College at San Luis Obispo (Tr. 106). His education was of course interrupted from February 28, 1944 to June 7, 1946 while he was serving in the armed forces of the United States.

Each of the sons participated in the control and management of the business. It was the cooperation and coordination of the two sons with their father that brought about the success of the business in obtaining the income which was obtained.

During the fall of 1941 the business of Walter Trepte, Builder, and his venture with Mr. M. H. Golden, as the Golden & Trepte Construction Company had grown beyond all expectations. The time had come when it was

necessary for Walter Trepte to surround himself with persons in whom he could have implicit confidence and trust. His two sons, Walter B. and Albert Eugene had from childhood worked with their father, knew and understood much about his work, they were the natural and logical persons to be associated with him. The government and individuals knew of the integrity and ability of both Mr. Trepte and Mr. Golden and sought after them to accept contracts for large and difficult projects (Tr. 165).

The opinion of the Tax Court appears to be partially based on the theory that Margaret Trepte, one of the petitioners herein, did not contribute capital originating with her; whereas it is clearly shown by the evidence that Walter and Margaret Trepte at the time of their marriage had no property and were at all times since their marriage residents of or domiciled in the State of California, a community property state. Under these circumstances there should be no question regarding her contribution of capital to the co-partnership.

Each of the sons obtained by purchase his co-partnership interest in the Trepte Construction Co. by signing a binding obligation in the form of a note (Exhibits 8 and 9). Each of the said notes was dated January 1, 1942, payable on demand, in the principal sum of \$29,-941.17 with interest at the rate of 3% per annum payable to Walter and Margaret Trepte, the petitioners herein. The sons had fully paid the notes together with interest by December 29, 1945. There was no element of gift involved, as the sons went into debt for their interest in the co-partnership and through their efforts and the efforts of their father and the coordination and cooperation of carrying on the business of the Trepte Construction Co., they were successful in discharging their obligations which they had previously incurred.

Before each co-partner's share of income is determined according to his or her per cent of ownership in the co-partnership there is determined the value of the services rendered by each of the respective co-partners. The additional share of the income of Walter B. Trepte for services rendered to the business was around \$4,800.00 a year, whereas the additional services of his father, Walter Trepte, is \$20,000.00 with the exception of the year 1944 when he received only \$10,000.00 because business had been slow, no additional amounts were allocated to the share of the co-partnership income to Margaret Trepte or Albert Eugene Trepte. (Tr. 80, 131, 132).

There is not one iota of evidence throughout the entire transcript which as much as makes an indication that this co-partnership was formed for the purpose of dividing the family income, reducing or avoiding taxes of any kind whatsoever. There was no mention of income tax or tax consequences in the discussions leading up to the formation of the co-partnership (Tr. 85, 116, 128, 159, 166 and 167).

Each of the sons had his independent retention of his share of the co-partnership which was only restricted until the notes (Exhibit 8 and 9) were fully paid and each exercised his independent right over his share of the profits as shown by their drawing and capital accounts, and neither their father nor their mother, attempted to deprive or hamper in any way the sons' control over their share of the profits.

The Tax Court, in its opinion, stated "Petitioner testified there was a gradual change into a partnership" (Tr. 49). This is an erroneous conclusion, as there was no gradual change over from Walter Trepte, Builder, to the Trepte Construction Co. Walter Trepte testified that the co-partnership did not immediately have new station-

ery printed or new checks, but had a rubber stamp made and over stamped his stationery, checks and records with the "Treppe Construction Co." (Tr. 134). This procedure is not an unusual occurrence and at that particular time stationery was exceedingly difficult to obtain.

All of the community property, assets, property, and business, subject to the liabilities of Walter Treppe, Builder, used to carry on the contracting and construction business, was duly assigned to the Treppe Construction Co. at the outset of the formation of the co-partnership, which assignment is clearly set forth in Exhibit 1.

Prior to the formation of the Treppe Construction Co., Walter Treppe had been conducting a joint venture with M. H. Golden under the name of the Golden & Treppe Construction Company and at the time of entering into the Articles of Co-partnership dated January 1, 1942, he duly assigned to the said co-partnership all of the assets, property and business subject to the liability which he had in the Golden & Treppe Construction Company, which was a one-half interest. His interest in the Golden & Treppe Construction Company was assignable as it was not personal in character. As authority for the proposition of his assignment of his interest in and to the Golden & Treppe Construction Company, we refer to the *Iowa Bridge Co. v. Commissioner*, 29 F (2d) Page 777.

There are numerous cases which sustain the petitioners' position that a co-partnership as in this case made, entered into, and carried on by the co-partners in good faith, constitutes a real, actual and bona fide co-partnership for all purposes and this position is supported by the case of *Thomas A. Walsh, Jr. v. Commissioner of Internal Revenue*,—F. 2d—(1948 Federal Tax Service, Prentice-Hall, Par. 72,635):

"The courts, in reliance upon the decisions of the Supreme Court, hold generally that a good faith partnership not designed for the purpose of channeling the income of one of the partners to other members of his family is valid for tax purposes; and that it is not essential that all members of the partnership shall have contributed services; it is necessary only that each member must in good faith have contributed either capital or services or both. as declared in the Tower case, *supra*.

For some recent cases sustaining the validity of family partnerships for tax purposes and reversing the Tax Court, see *Kent v. Commissioner*, 6 Cir.,—F. 2d—(decided September 27, 1948); *Culbertson v. Commissioner*, 5 Cir., 168 F. 2d 979; *Canfield v. Commissioner*, 6 Cir., 168 F. 2d 907; *Woosley v. Commissioner*, 6 Cir., 168 F. 2d 330; *Weizer v. Commissioner*, 6 Cir., 165 F. 2d 772; *Lawton v. Commissioner*, 6 Cir., 164 F. 2d 380; *Wilson v. Commissioner*, 7 Cir., 161 F. 2d 661; *Durwood v. Commissioner*, 8 Cir., 159 F. 2d 400; *Hartz v. Commissioner*, 8 Cir.,—F. 2d—(decided October 27, 1948); and for appeals from district courts sustaining family partnership contracts see: *Allen v. Knott*, 5 Cir., 166 F. 2d 798; *Arnold v. Schepps*, 5 Cir., 166 F. 2d 821. Recent cases in this court affirming decisions of the Tax Court holding such partnerships invalid for tax purposes are: *Kohl v. Commissioner*, 8 Cir.,—F. 2d—; *Supornick v. Commissioner*, 8 Cir., 150 F. 2d 110 (33 AFTR 1507); and *Doll v. Commissioner*, 8 Cir., 149 F.2d 239 (33 AFTR 1264).

For the reasons stated above the decision of the Tax Court is reversed."

There are many facts in the case of *Walter J. Runyon v. Commissioner*, 8 TC 350, which are analogous to the proceedings in the case before this Court.

The case of *William F. Fischer v. Commissioner*, 5 TC 507, in many respects bears a similarity to the instant case.

Some of the same problems arose in the case of *Ross B. Hammond v. J. W. Maloney*, Collector of Internal Revenue, Fed. Sup.-Vol. 80 No. 1, 212 (DC Ore. April 21, 1948).

With the exception of a different type of enterprise the case of *W. O. Culbertson, Sr. and Gladys Culbertson v. Commissioner of Internal Revenue*, 168 F (2d) 979 is practically on all fours with the case now before this Court. In the *Culbertson* case the father sold an interest to his four sons who gave their notes therefor, which was held to be valid, a balance of which remaining unpaid on the notes was cancelled as a gift. Such amounts as were paid on the notes of the sons were derived from their share of the profits in the business of cattle raising, whereas in the case now before this Court, no part of the notes of the sons was cancelled, and interest was paid on the said notes which came from their share of the profits of the *Trepte Construction Co.* contracting and building business. In the *Culbertson* case, Mr. W. O. Culbertson gave to his daughter an interest in his own cattle, whereas in the *Trepte* case their daughter was excluded from the co-partnership, as it was felt that she could lend no benefit to the co-partnership. Also, in the *Culbertson* case, the business had been carried on for a period of nearly a quarter of a century, whereas in the instant case, the business has been carried on for nearly a half of a century.

We submit that statements of the Court in the *Culbertson* case actually paraphrase almost identical facts in the

Trepte case and its conclusions drawn are identical with those that must be drawn from the evidence in the Trepte case, quoting:

‘‘It was the purpose and intent of all the parties to form an actual, real, and bona fide partnership between Culbertson and his four sons, with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership. We do not consider that it is illegal, income-tax-wise or otherwise, for a partnership to be formed in consideration, or contemplation, of services rendered, or to be rendered, by the partners. The fact that the boys were called into the military service by the United States, as well as the fact that some of them had not, during the tax period, completed their education so as to devote their full time and attention to the partnership is in no wise indicative that the partnership was formed for the purpose of dividing the family income, or for the purpose of income tax savings. The failure by a partner to render service to the partnership or to contribute capital originating in him, is, after all, but a circumstance to be considered in determining the reality or actuality of an alleged family partnership. The failure to do either is not a condition precedent.

There is no evidence but that the partnership was entered into validly and in good faith, * * * that this partnership was entered into without any idea, purpose, or thought of the tax consequences but with the idea of carrying on the breeding of fine Herefords in the traditions of that section of the country. * * *

To conclude in this case that the plan and purpose of an aging father to enlist the interest and services

of his four ranch-reared, experienced, and stalwart sons in the carrying on of his and his partner's life work was not for the partnership's benefit seems to require the exaltation of suspicion over the realities to an extent that the exigencies of the times for tax collection neither deserve nor demand. * * *

It seems that out of the cases of *Lusthaus v. Commissioner*, *supra* and *Commissioner v. Tower*, *supra*—which cases were properly decided on their peculiar facts—a concept has been born and is carefully nurtured by the tax collecting agencies that no partnership is valid—*income-tax-wise*—between members of a family unless the members of the family coming into the partnership actually contribute money or had actually, theretofore, rendered services. Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time that he is taken into it.

These tests are equally effective whether the capital and the services are presently contributed and rendered or are later to be contributed or to be rendered. Moreover, a partnership is formed to act in the future and not in the past and when it is fully expected, intended, and agreed that the incoming partner will render services to the partnership, the Government should not be heard to say: "I will not recognize you as a partner even though you in good faith entered into it. I took you into the Army to fight a war and you did not perform services for the partnership as you had agreed to do."

The inquiry as to a family partnership for income tax purposes must relate to evidence bearing on the reality, the actuality, and the bona fides of the trans-

action, or the absence thereof. Where the proof conclusively shows that a family partnership was entered into for the benefit of the business and not the purpose of evading, avoiding, or dividing, income taxes, it will be deemed a partnership for income tax purposes even as it is recognized in the law for all other purposes. * * *

We think that the evidence shows conclusively that the partnership here was actual, real, bona fide, and entered into for the benefit of the partnership, with no thought of income taxes and no purpose to evade, divide, or defeat their collection."

We further submit that the evidence shows conclusively that the co-partnership was entered into and carried on in good faith, it was actual, real, and bona fide, and entered into for the benefit of the co-partnership with no thought of income taxes and with no purpose of dividing the family income to evade, divide, or defeat income taxes.

Conclusion

On the basis of the law and facts, it is submitted that the petitioners are entitled to have their individual income and victory taxes computed for the years 1942 and 1943 as co-partners of the Trepte Construction Co. pursuant to the Articles of Co-partnership, which come within the provisions of sections of the Internal Revenue Code as set forth in the Appendix, and that the decisions (Tr. 52 and 53) of the Tax Court of the United States should be reversed wherein it found deficiencies in income and victory taxes for the year 1943 against Walter Trepte in the sum of \$23,183.84 and against Margaret Trepte in the sum of \$29,480.82.

Respectfully submitted

GEORGE H. STONE

Wm. D. MORRISON

Counsel for Petitioners

APPENDIX

Internal Revenue Code:

"SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

"SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

"SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

(b) *Segregation of Items.*—

(1) *Capital gains and losses.*—There shall be segregated the gains and losses from sales or exchanges of capital assets.

(2) *Ordinary net income or loss.*—After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(c) Charitable Contributions.—In computing the net income of the partnership the so-called “charitable contribution” deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

(d) Standard Deduction.—In computing the net income of the partnership, the standard deduction provided in section 23 (aa) shall not be allowed.

“SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

“SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * *

(2) *Partnership and partner.* — The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not,

within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization."

United States Treasury Department Regulations III:

SEC. 29.181-1. *Partnerships.* — Partnerships as such are not subject to the income tax imposed by chapter 1, but are required to make returns of income. (See sections 187 and 188). For definition of what the term "partnership" includes, see section 3797(a)(2).

"SEC. 29.182-1. *Distributive share of partners.*—

(a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

- (1) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.
- (2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.
- (3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(b) If separate returns are made by the husband and wife domiciled in a community property State, and the husband only is a member of a partnership, the part of his distributive share of gains and losses from sales or exchanges of capital assets or the part of his distributive share of ordinary net income or ordinary

net loss, which is, or is derived from, community property should be reported by the husband and by the wife in equal proportions. * * *

"SEC. 29.183-1. *Computation of partnership income.*—The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that:

- (1) The partnership is required to segregate its gains and losses from sales or exchanges of capital assets. A partnership is not allowed the benefit of section 117 (e).
- (2) The partnership is further required, after excluding all items described in paragraph (1), to compute (a) an ordinary net income which consists of the excess of the gross income over the deductions, or (b) an ordinary net loss which consists of the excess of the deductions over the gross income. * * * Payments made to a partner for services rendered and for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partnership profits.

"SEC. 29.187-1. *Partnership returns.*—Every partnership shall make a return of income, regardless of the amount of its net income (see section 3797(a) (2) defining the term "partnership"). The return shall be on Form 1065; shall state specifically the information required to be stated by the return form; shall be filed in according to the instructions contained thereon or issued with respect thereto; and shall be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year, as the case may be), irrespective of the taxable years of the partners. (See sections 182 and 183). * * *

No. 12078

**In the United States Court of Appeals
for the Ninth Circuit**

WALTER TREPTE AND MARGARET TREPTE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX
COURT OF THE UNITED STATES**

BRIEF FOR THE RESPONDENT

THERON LAMAR CAUDLE,

Assistant Attorney General.

ELLIS N. SLACK,

A. F. PRESCOTT,

SUMNER M. REDSTONE,

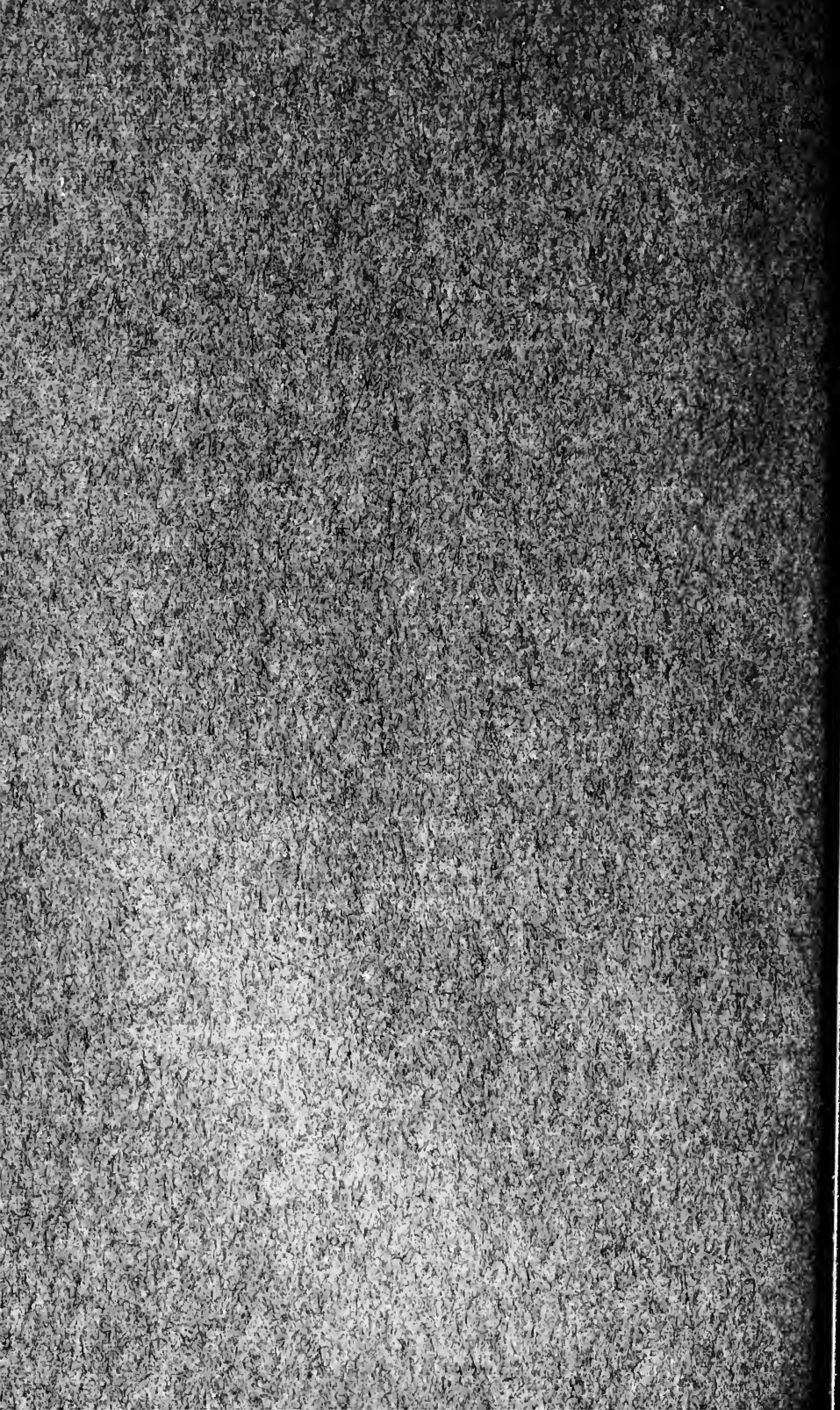
*Special Assistants to the
Attorney General.*

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**In the United States Court of Appeals
for the Ninth Circuit**

No. 12078

WALTER TREPTE AND MARGARET TREPTE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX
COURT OF THE UNITED STATES*

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 29-51) are not officially reported.

JURISDICTION

The petition for review (R. 54-64) involves federal income taxes for the years 1942 and 1943. On August 23, 1946, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiency in the total amount of \$52,664.66. (R. 4, 16.) Within 90 days thereafter and on November 18, 1946, the taxpayers filed petitions with the Tax Court for a redetermination of the deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 4-14, 16-26). The decision of the Tax Court sustaining the deficiencies were entered May 28, 1948. (R. 52, 53.) The case is brought to this Court by a petition for review filed

August 23, 1948 (R. 54-64), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

1. Did the Tax Court properly determine that the family partnership established between taxpayers and their children was not bona fide for federal revenue purposes?

2. Did the Commissioner properly determine, in the alternative, that the attempted assignment by taxpayer to the partnership of his interest in the joint venture known as the Golden-Trepte Construction Company, whose assets consisted largely of construction contracts, was ineffective for federal revenue purposes?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22 [as amended by Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1]. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gain, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1946 ed., Sec. 181.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22 (a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *

* * * * *

STATEMENT

The facts as found by the Tax Court are set out as follows (R. 29-46):

Walter Trepte (hereinafter and sometimes referred to as taxpayer) and Margaret Trepte are husband and wife and have resided in San Diego, California, since some time prior to their marriage in 1916. Neither taxpayer nor his wife had any property prior to their marriage. All property held by either of them is community property. Income tax returns for the periods here involved were filed with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles. (R. 29.)

Taxpayer's father started in the construction business at San Diego, California, in 1895. From 1910 to 1912, taxpayer studied structural design at California School of Mechanical Arts, San Francisco. From 1912 to 1917 he worked for his father; the last two years of

this period were spent on a ranch, owned by his father, in the Imperial Valley. (R. 29.) In 1917, taxpayer's father and a partner, one Rambo, were conducting the business. At that time taxpayer gave his father a note for Rambo's share of the business, after which taxpayer and his father conducted the business as a partnership. The note was paid out of taxpayer's share of the earnings. (R. 29-30.)

In 1928, taxpayer bought his father's interest in that partnership. The dissolution was effected by a property division and a cash settlement. Thereafter, taxpayer operated his general contracting business under the name of "Walter Trepte Builder," as a sole proprietorship until the date of the creation of the alleged partnership of Trepte Construction Company on January 1, 1942. (R. 30.)

The business of taxpayer's father was commercial and engineering contracting. Taxpayer continued in this same field after he acquired the business in 1928. The work is technical in that it requires a knowledge of and skill in construction engineering, material and labor markets for the purpose of submitting bids. Taxpayer's architectural engineer education gave him real assistance in this phase of the business. (R. 30.)

Some time prior to July 6, 1940, taxpayer and one M. H. Golden associated themselves as joint venturers to operate as "Golden-Trepte Construction Co.," (hereinafter sometimes referred to as Golden-Trepte) for the purpose of engaging in contracting work for the Federal Government. Golden-Trepte obtained a large contract from the Navy Department for various types of construction in and around the naval facilities in the San Diego area. (R. 30-31.) The contract was signed by taxpayer and Golden, individually, on July 6, 1940. The contract was approved by the Navy Department on July 11, 1940. The contract, as it originally existed,

contemplated construction work in the amount of approximately \$3,500,000. However, it was extended to cover projects which eventually had a cost of about \$21,000,000. Under the contract, Golden-Trepte was required to obtain all material and supply all labor. The projects contemplated by this contract and extensions were completed in 1944. Work was begun in 1940. This contract was not obtained on bid but was negotiated at the request of the Navy. (R. 31.)

While engaged on the various projects under the Navy contract, Golden-Trepte also undertook other contract work for various governmental agencies and private corporations, including one fuel-depot project for the Navy which was not included in the above contract. Construction jobs were undertaken for Rohr Aircraft Company, as agent for Defense Plant Corporation, and San Diego Gas & Electric Company. The fuel-depot job and the Rohr Aircraft job had value of approximately \$1,750,000. In addition to these, the Trepte Construction Company also did work for some customers, particularly the Ryan Aircraft Company. Taxpayer had a crew at Ryan from 1939 until the end of the war. (R. 31.)

The Navy contract provided that Golden-Trepte should designate a construction superintendent to have complete charge of all work under the contract. (R. 31.) It further provided that no person shall be assigned as superintendent, chief engineer, chief purchasing agent, chief assistant, or similar position in the field organization or as principal assistant to such persons, until the contracting officer shall approve the qualifications and experience of the person proposed for such assignment. The Rohr contract provided that the "contractor" (Golden-Trepte) shall keep on the job, at all times, a qualified representative, satisfactory to the other contracting party. (R. 31-32.)

Prior to January 1, 1942, taxpayer had between 75 and 100 employees in his individual business. Golden-Trepte had about 1,500 employees at the peak, which was reached in December 1941. The foreman and superintendent and others who had technical skills giving them responsibility comprised approximately 10 to 20 per cent of the employees for both organizations. (R. 32.)

In the summer of 1941, the Navy contract was extended to include certain construction on San Clemente Island, about 100 miles off the coast of San Diego. Taxpayer flew out to the project about once a week; due to fog, it was very hazardous. On an earlier trip the plane had nearly crashed and at that time he and Golden discussed what would become of the Navy contract in the event of one or both of their deaths, so taxpayer told Golden that he "had been considering having his sons go into partnership" with him, and that he thought that "they should get one formed" as soon as they could to carry on the business if anything happened to them. (R. 32.)

Taxpayer discussed the desirability of a "partnership" with his wife and two sons on several occasions and pointed out to them how he had been a "partner with his father" and showed them the advantage of coming into a "business which already had an established name for honesty and integrity." The latter part of 1941, taxpayer consulted an attorney about drawing up a partnership agreement, and a written "partnership agreement," effective January 1, 1942, was executed, naming as partners taxpayer, his wife and sons, Walter B. Trepte and Albert Eugene Trepte. (R. 33).

A certificate of doing business under a fictitious name, dated May 11, 1942, was filed with the State of California. On April 18, 1942, taxpayer and his wife executed an instrument entitled "Declaration of Eman-

ipation of Minor," which purported to free Albert Eugene Trepte from all control by his parents as of January 1, 1942. On April 22, 1947, after he attained his majority, Albert executed an instrument purporting to ratify and confirm his act in executing the document entitled "Articles of Co-Partnership," dated January 1, 1942. (R. 33.)

In the preamble, the Articles of Co-Partnership recite as follows (R. 33-34):

That, Whereas, Wlater [sic] Trepte has for some time past been conducting a general contracting business in the City of San Diego, California, and also has been conducting a joint venture with M. H. Golden under the name of Golden & Trepte Construction Company, and

Whereas, said M. H. Golden and Walter Trepte in the fall of 1941 agreed among themselves to each form a separate family partnership as of January 1, 1942 for the ownership, management and operation of their respective contracting business and to include in their respective family partnerships the assets, accrued earnings and future earnings of said Golden & Trepte Construction Company, and

Whereas, said Walter Trepte has conveyed to the parties hereto all of his interest in his contracting business and his interest in the assets, accrued earnings and future earnings of said Golen [sic] & Trepte Construction Company, and the parties hereto desire to hold all of said property as co-partners and to operate said contracting business as a co-partnership.

The "Partnership Agreement" provided (R. 34-35) that taxpayer and his wife each have a 26 per cent interest and each of the boys have a 24 per cent interest; that the "company" shall have an existence of 20 years from January 1, 1942; also, the capital of the partnership shall consist of—

Office equipment, planing mill equipment, trucks, machinery, cash in the bank, accounts receivable, naval air station job equity, being the equity in the partnership assets of Golden & Trepte Construction Company, and all other personal property now used by Walter Trepte in said business and also the good will of said business subject to all the liabilities of said business as of January 1, 1942, which appear on the books of said Walter Trepte as of said date, as follows:

Assets

Cash in bank	\$29,197.68
Accounts Receivable	48,023.52
Work in Progress	29.06
Naval Air Station job equity *	88,458.88
Miscellaneous building material....	1,846.81
Fixed equipment cost... \$14,147.12	
Depreciation	3,510.14
	<hr/>
Net	\$10,636.98
	<hr/>
Total Assets	\$178,192.93

Liabilities

Accounts payable	\$15,079.36
Notes payable to banks.....	35,000.00
Reserve for insurance	612.91
Reserve for social security taxes...	1,145.23
Reserve for North Island Equip- ment	1,600.54
Rental Adjustment	
	<hr/>
Total Liabilities	\$53,438.04
	<hr/>
Net Worth	\$124,754.89

* This item consisted of petitioner's interest in money owed to Golden-Trepte by the United States Navy, for labor and material furnished under the contract.

Each of the sons executed and delivered to his parents a promissory note in the amount of \$29,941.17, the "purchase price" of their respective interests in the alleged partnership. (R. 35.)

The agreement provided that taxpayer should be general manager of the "Partnership." His duties as manager of the "partnership" were substantially the same as his duties as sole owner of the business before January 1, 1942. (R. 35.)

Each "partner" was to share in all profits and losses to the extent of the respective interest of each. (R. 35.) The agreement further provided as follows (R. 36):

After the payment of salaries and certain allowances which shall be fixed from time to time by partners holding a majority interest all profits arising from the operation of said partnership shall be added to the capital of said partnership so long as such a majority interest so decides or in the discretion of the holders of a majority interest may be distributed but any distribution to the partners, Walter B. Trepte and Albert Eugene Trepte, will first be applied upon the payment of any outstanding balance of their notes before distribution be made to them individually.

The agreement provided that deposits to the partnership bank account could be made for the "partnership" by any "partner" or agent of the "partnership." Checks could be drawn on any partnership account by such of the "partners" and their agents as were chosen from time to time by holders of a majority interest. (R. 36.)

The agreement further provided (R. 36-37):

No partner shall during the continuance of the partnership carry on any business in competition with, or be concerned or interested directly or indirectly in the same kind of business as that carried on by the partnership in the County of San Diego,

State of California, without the consent in writing of the other parties hereto, except consent is hereby given to Walter Trepte to carry on the business of Golden & Trepte Construction Company and other partnerships, joint ventures or corporations.

Since the time and efforts of partner Walter Trepte belong to said family co-partnership, and since the investment in the joint venture of Golden & Trepte Construction Company also belongs to the Trepte Construction Company, such of his time as may be spent on the joint ventures of Golden & Trepte Construction Company shall be considered partnership property and the resulting earnings of the Golden and Trepte joint venture shall be partnership earnings.

That any and all earnings from personal services outside of this family co-partnership shall be given due consideration in allocating partnership profits and losses.

Walter B. Trepte, the son of taxpayers herein, and one of the alleged partners, was born in San Diego, California, on November 6, 1918, and was 23 years of age on January 1, 1942. He went through high school, and had one-half year of college work at California State College. Prior to January 1, 1942, the alleged date of the partnership, Walter was employed at various times on his father's construction business. He so worked in the summers of 1935 and 1936, the fall of 1938, the entire year of 1939, and from July of 1940. In 1935 and 1936, he worked as a truck driver. In 1938, he did clerical work as assistant to the bookkeeper and timekeeper. For the remainder of 1940, he was employed by Golden-Trepte in the timekeeping office at the naval facility at North Island. He remained in this position until June 1941, when he went to the job at the Naval fuel depot, for Golden-Trepte. (R. 37). At the fuel depot he was in charge of personnel and timekeeping, did some bookkeeping and certain se-

curity work. (R. 37-38.) He hired and fired employees on the authority of Trepte or Golden. Certain employees, those on an hourly or day-to-day basis, he hired or fired as the need for their services rose or fell. From 1935 through 1941, he was carried on the pay rolls as an employee. His compensation ranged from \$15 per week in the beginning to \$35 per week in 1941 when he worked for Golden-Trepte. (R. 38.)

After the formation of the "partnership" on January 1, 1942, Walter B. Trepte worked for Golden-Trepte at the fuel depot. In June or July he went to the Golden-Trepte job at Rohr Aircraft Corporation, and in October or November he went back to the Golden-Trepte job at the Naval Air Station, where he remained until the completion of the contract in October or November of 1943. From October or November 1943, until the middle of 1944, he worked for the "partnership" at Rohr Aircraft, and following that he worked about four months at the Naval Air Station for Golden-Trepte. Since that time he has worked on Trepte Construction Company projects. Prior to January 1, 1942, Walter B. Trepte had never assembled the data necessary to prepare a bid for construction work, though he did help taxpayer and estimators employed by taxpayer to do so. Between January 1, 1942, and December 31, 1943, he assisted in the same manner. The work Walter B. Trepte performed prior to January 1, 1942, was done under taxpayer's supervision. (R. 38.) Much of the work after that date up to December 31, 1943, was also under taxpayer's supervision. (R. 38-39.) Some of the work performed during this period was approved by the "officer in charge of the Navy." From January 1, 1942, on, he was paid a regular salary of \$55 per week by Trepte Construction Company. He received extra remuneration from Rohr Aircraft job which was put into the "partner-

ship." For the years 1943, 1944, 1945 and 1946, year-end bookkeeping entries were made on books of Trepte Construction Company, purporting to adjust Walter B. Trepte's salary to a basis of \$4,800 per year. (R. 39.)

A drawing account was set up in the books of the "partnership" for Walter B. Trepte. His salary was charged to it and also certain other personal expenses, payments made on the note held by his parents, and all withdrawals for payments of federal and state income taxes. He also had a "capital account" in the books to which was credited his purported original 24 per cent interest and a like proportion of the subsequent profits from the "partnership" for each year. He has seen his drawing and capital accounts each year, but his examination was cursory and for his own information. He is not an accountant though he does understand something about the theory of accounting. (R. 39.)

Walter B. Trepte was authorized by the majority-interest partners to sign checks on the accounts of the Trepte Construction Company as provided in the alleged partnership agreement and did sign them. (R. 39.) He also signed checks on his father's account while the business was under the name of Walter Trepte, Builder. (R. 39-40.) Other persons also had authority to sign checks for Trepte Construction Company. (R. 40.)

All payments made by Walter B. Trepte on his note, held by his parents, and all payments for federal and state income taxes were made from profits of the business of Trepte Construction Company. (R. 40.)

The construction business requires one's having knowledge and experience in order to make bids for jobs, and prior to 1942 taxpayer was the only one qualified to do this work, though he hired estimators who prepared estimates which were ultimately approved or disapproved by him. After 1942, the same has gen-

erally been true, although since 1941 all or most of the construction work performed by Walter Trepte, Builder, has been on government contract. Walter B. Trepte had no inclination toward that technical end of the business. (R. 40.)

Albert Eugene Trepte, son of taxpayers herein and one of the alleged partners in Trepte Construction Company, was born September 8, 1925. He was 16 years of age on the date of creation of the alleged partnership. He worked for his father in the construction business in the summer of 1941 at the Naval fuel depot as crewman on a small craft and on a pile driver. In the summer of 1942, he worked on the Ryan Aircraft Company job as an assistant carpenter. On the fuel-depot job he received 75 cents per hour and 85 cents per hour on the Ryan job. He went to summer school in 1943. (R. 40.) On February 28, 1944, he was drafted into the United States Navy and was discharged June 7, 1946. (R. 40-41.) During part of 1946, he worked "down there in a capacity of rustling material." In 1947, he worked in the office taking care of bills. In September 1946, he entered on a course of study in architectural engineering at California State Polytechnic College at San Luis Obispo. This is a two-year course. (R. 41.)

The note given by Albert Eugene Trepte for his alleged interest in the Trepte Construction Company was paid from profits of the business. The "Company" paid for his personal needs, including clothing, recreation, tuition, school, expenses. It also paid his federal and state individual income taxes. All of these items were charged against a drawing account in his name on the books of Trepte Construction Company. (R. 41.)

In 1942, 1943, 1945 and 1946, taxpayer drew \$20,000 per year as salary from the alleged partnership. In

1944, due to decreased business, he drew \$10,000. (R. 41.)

Taxpayer was reasonably familiar with the various revenue bills of 1940, 1941 and 1942. He was reasonably familiar, from previous experience, with the amount of tax he would have to pay on his profits. He had a certified public accountant audit his books and prepare returns before the "partnership" and the same person performed similar work after the date of the creation of the alleged partnership. (R. 41.)

The books (Account No. 293) of Trepte Construction Company show the following as to withdrawals by Walter B. Trepte (R. 41-42) :

Year	Note and Interest	Collector of Internal Revenue	Franchise Tax Commission	Checks drawn to Walter B. Trepte	Checks drawn for Walter B. Trepte	Total
1942**				\$495.00		\$495.00
1943***	\$11,554.74	\$14,036.58	\$776.39	2,085.00	\$10.30	28,463.01
1944.....	10,802.38	6,682.24	446.88		7.55	17,939.05
1945.....	10,500.00	1,740.59	104.38		20.00	12,364.97
1946.....		24,827.76	638.46	100.00	591.53	26,157.75
1947****		6,727.80	648.21		1,211.11	8,587.12
Total.....	\$32,857.12	\$54,014.97	\$2,614.32	\$2,680.00	\$1,840.49	\$94,006.90*

*Total discrepancy of \$5,862.37 between stipulation and amount shown in capital account not explained. Discrepancies appear in years 1942-3-4-5-6.

**The date of the first withdrawal recorded on the books was Nov. 2, 1942.

***First entry other than \$55.00 salary payment—March 19, 1943.

****Last entry included here—Sept. 26, 1947.

The books of Trepte Construction Company show the following as to "capital of Walter B. Trepte" (R. 43) :

Date	Descriptive Particulars	Debits	Credits	Balance
Mar. 31, 1943	Transfers of capital from Walter Trepte.....		\$28,941.17	\$28,941.17
Mar. 31, 1943	Profit and Loss 1942.....		29,665.07	58,606.24
Sept. 18, 1943	Adj. error in previous entry recording share purchased from Walter Trepte.....		1,000.00	59,606.24
Feb. 16, 1944	Closing 1943 entries.....	\$26,877.05		
Feb. 16, 1944	Closing 1943 entries.....		23,664.00	56,393.19
Dec. 30, 1944	Walter B. Trepte withdrawals.....	17,843.71		
Dec. 30, 1944	Profit and Loss 1944 Distribution..		8,336.56	46,886.04
Dec. 31, 1945	Walter B. Trepte withdrawals.....	10,472.65		
Dec. 31, 1945	Profit and Loss 1945 Distribution..		25,389.29	61,802.68
Dec. 31, 1946	Walter B. Trepte withdrawals.....	24,364.00		
	Profit and Loss 1946 Distribution..		25,067.35	62,506.03

The books (Account No. 294) of Trepte Construction Company show the following as to "withdrawals by Albert Eugene Trepte" (R. 44):

Year	Note and Interest	Collector of Internal Revenue	Franchise Tax Commission	Checks drawn to Albert Eugene Trepte	Checks drawn for Albert Eugene Trepte	Total
1943*	\$11,554.74	\$12,413.21	\$987.11	\$750.00	\$5.00	\$25,710.06
1944.....	10,529.78	5,302.29	346.76	.....	676.88	16,855.71**
1945.....	10,463.27	52.23	55.65	.....	.....	10,571.15
1946.....	.....	20,110.97	428.77	500.00	186.23	21,225.97
1947***	.....	4,800.55	417.13	750.00	44.80	6,012.48
	<u>\$32,547.79</u>	<u>\$42,679.25</u>	<u>\$2,235.42</u>	<u>\$2,000.00</u>	<u>\$912.91</u>	<u>\$80,375.37</u>

*First entry recorded on the books—March 27, 1943.

**\$209 unexplained discrepancy between stipulation and amount shown in capital account.

***Last entry included here—September 3, 1947.

The books of Trepte Construction Company show the following as to "capital of Albert Eugene Trepte" (R. 45):

Date	Descriptive Particulars	Debits	Credits	Balance
Mar. 31, 1943	Transfer of capital from Walter Trepte.....		\$28,941.17	\$28,941.17
Mar. 31, 1943	Profit and Loss—1942.....		29,665.07	58,606.24
Sept. 18, 1943	Adj. error in previous entry recording share purchased from Walter Trepte.....		1,000.00	59,606.24
Feb. 16, 1944	Closing 1943 Entries.....	\$25,710.06		
Feb. 16, 1944	Closing 1943 Entries.....		23,664.00	57,560.18
Dec. 30, 1944	Albert Eugene Trepte withdrawals..	16,646.71		
Dec. 30, 1944	Profit and Loss 1944 Distribution..		8,336.56	49,250.03
Dec. 31, 1945	Albert Eugene Trepte withdrawals..	10,571.15		
Dec. 31, 1945	Profit and Loss 1945 Distribution..		25,389.28	64,068.16
Dec. 31, 1946	Albert Eugene Trepte withdrawals..	21,225.97		
Dec. 31, 1946	Profit and Loss 1946 Distribution..		25,067.35	67,909.54

Partnership returns of income filed with the Collector of Internal Revenue for the Trepte Construction Company showed the following in schedule J (R. 46):

Name	1942		1943	
	Ordinary Net Income	Long Term Gain	Ordinary Net Income	Long Term Gain
Walter Trepte.....	\$60,822.35	\$686.93	\$44,467.92	\$584.05
Margaret Trepte.....	57,054.46	644.37	24,980.04	327.98
Walter B. Trepte.....	29,529.06	333.49	25,523.78	335.11
Albert E. Trepte.....	29,009.80	327.63	23,058.26	302.87
Total.....	<u>\$176,415.67</u>	<u>\$1,992.42</u>	<u>\$118,030.00</u>	<u>\$1,550.01</u>

SUMMARY OF ARGUMENT

The record overwhelmingly supports the determination of the Tax Court that no valid partnership was established between taxpayers and their children for federal revenue purposes. The sons contributed no capital to the business "originating" with them. Their alleged purchase of the business assets by the execution of notes to their parents, to be satisfied out of the business earnings, did not constitute a contribution. The assets of the business remained exactly the same. The services rendered to the business by the younger son, Albert Eugene, were obviously negligible. Although the older son did work steadily for the business before, during, and after the taxable years involved, the record fully justifies the determination of the Tax Court that his services were largely clerical, were not "vital" and were adequately compensated for by his salary. Moreover, taxpayer continued to dominate the business subsequent to the formation of the partnership as before; and under the partnership agreement he exercised extensive control over its assets, its profits and every phase of the business operations. This being so, his economic status remained in substance unchanged. Since the determination of the Tax Court that the partnership was not bona fide for federal revenue purposes is patently not clearly erroneous, it may not be disturbed on appeal.

Although the Tax Court was not required to reach the second question, in view of its decision on the first, it is nevertheless manifest that the Commissioner properly determined that taxpayer's attempted assignment of his interest in the Golden-Trepte joint venture constituted an assignment of his past and future earnings and was thus ineffective for federal revenue purposes.

I

The Record Fully Supports the Determination of the Tax Court That the Family Partnership Established by the Taxpayers and Their Children Is Not Bona Fide for Federal Revenue Purposes

Since the principal issue presented on this appeal is the validity of a so-called family partnership for federal income tax purposes, no extensive recitation or analysis of authorities is requisite. Suffice it to point out that although such partnerships may not be discriminated against as such, the trial court is justified in concluding that the alleged partnership lacks reality unless the transferee partner "invests capital originating with her [him] or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things." *Commissioner v. Tower*, 327 U. S. 280, 290; *Lusthaus v. Commissioner*, 327 U. S. 293. In addition, other criteria may be examined as bearing on the *bona fides* of the arrangement, such as the extent of control which the taxpayer continues to exercise over the partnership business, the extent of profit distribution to the transferee partners, the alienability of the partnership interest, and the motives leading to the formation of the partnership. *Belcher v. Commissioner*, 162 F. 2d 974 (C. A. 5th), certiorari denied, 332 U. S. 824. In each case the ultimate objective is the taxation of income to those who actually earn it or create the right to receive or enjoy it. The existence of a capital contribution, the rendition of vital additional services, and the genuineness of the family partnership arrangement are in every case questions of fact, to be determined by the trial court; and its findings may not be disturbed on appeal unless clearly erroneous. *Nordling v. Commissioner*, 166 F. 2d 703 (C. A. 9th), certio-

rari denied, 335 U. S. 817; *Blalock v. Allen*, 151 F. 2d 927 (C. A. 5th). An examination of the evidence in the instant case in the light of the standards set out above makes manifest the correctness of the lower court's determination.

The undisputed evidence discloses that no capital "originating" with the transferee partners was invested in the partnership business. Taxpayer had operated his general contracting business, the assets of which were owned in community with his wife, as a sole proprietorship since 1928. (R. 30, 65.) In the latter part of 1941 taxpayer consulted an attorney about drawing up a partnership, and a partnership agreement was executed, the partnership consisting of the taxpayer, his wife, and his two sons, Walter B. Trepte and Albert Eugene Trepte. At the time of the formation of the partnership the former was twenty-three years old and the latter sixteen. (R. 66.) On April 18, 1942, taxpayer and his wife executed a "Declaration of Emancipation of Minor" providing for the emancipation of Albert Eugene Trepte from the disabilities of minority as of January 1, 1942. (R. 67.) Under the partnership agreement taxpayer and his wife each retained a 26 percent interest in the business and each of their sons obtained a 24 percent interest. (Ex. 1, p. 3.) The sons purportedly "paid for" their respective interests by executing promissory notes in the amounts of \$29,941.17, the alleged "purchase price." (Ex. 1, p. 3; R. 35.) The notes were to be paid out of the sons' shares of the earnings of the business. (Ex. 1, p. 3; R. 36.) No argument is requisite to demonstrate that no new capital was required or obtained by taxpayer as a consequence of this arrangement. The assets of the business remained exactly the same. Indeed, in this respect, the case is almost on all fours with the *Lusthaus* case, *supra*, where the wife similarly

signed notes and subsequently paid them off out of the earnings of the business. The Supreme Court held there that the wife did not contribute capital "originating" with her. The contention of the taxpayer that his sons contributed capital originating with them by virtue of their execution of promissory notes for the "purchase" of the assets, and the satisfaction of the notes out of the business earnings is similarly inconsistent with this Court's recent decision in *Nordling v. Commissioner, supra*.

It is equally manifest that, as the Tax Court found (R. 48), neither son rendered vital additional services to the business. The most cursory analysis of the record suffices to demonstrate that the services rendered by Albert Eugene Trepte, who was sixteen years old at the time of the formation of the partnership, were negligible. Prior to the formation of the partnership, Albert Eugene Trepte had worked for the taxpayer during the summer of 1941 as a crewman on a small craft, receiving as compensation 75 cents an hour. Subsequent to the formation of the partnership he worked for taxpayer during the summer of 1942 as an assistant carpenter, receiving the sum of 85 cents an hour. (R. 104-105, 47.) He rendered no services during 1943, entered the United States Navy in 1944, and was not discharged until 1946. (R. 103.) Shortly thereafter he entered college. (R. 106.) It is not easy to understand how it can seriously be contended that any portion of the partnership earnings was attributable to a contribution of capital or services by Albert Eugene Trepte.

As for Walter B. Trepte, though it be true that he did work regularly for the taxpayer, the Tax Court was nevertheless justified in its determination that his services were not vital; that they were largely of a clerical nature; and that they were in essence the serv-

ices not of a partner but of an employee, for which Walter was adequately compensated. (R. 48.) At the outset, it should be noted that the taxpayer's business consisted of the construction of buildings, factories, warehouses, bridges, roads, et cetera, and involved millions of dollars of contracts. (R. 127, 137-138.) The operation of the business required a knowledge of and skill in engineering and construction engineering, materials, labor markets, prices, et cetera. (R. 138.) Although taxpayer himself had studied structural designing for two years as a young man, and this education was of great assistance to him (R. 121-122), Walter B. Trepte's education in the field of engineering and construction consisted of his starting an economics course during his one term of college (R. 75, 154). In fact, taxpayer's wife, Margaret Trepte, testified that taxpayer was the only one among the four who at the time of the formation of the partnership had the necessary education, training and skill, technically and otherwise, to carry on the business (R. 118), and this was confirmed by the testimony of Walter B. Trepte himself (R. 94-95). It seems clear from the record that Walter B. Trepte had no particular inclination toward or interest in the technical aspects of the business (R. 153-154, 40), and yet it is difficult to conceive of a business which requires more in the way of technical training and interest than taxpayer's business. Prior to January 1, 1942, Walter B. Trepte was employed in taxpayer's construction business during the summers of 1935 and 1936, the fall of 1938, the entire year of 1939, and the latter half of 1940. (R. 37, 76.) In 1935 and 1936 he worked as a truck driver, did clerical work as an assistant to the bookkeeper and timekeeper in 1938, and was employed by the Golden-Trepte joint venture in the time keeper's office in 1940. (R. 76.) In 1941 he was in charge of personnel and

time keeping and did some bookkeeping and security work for Golden-Trepte. (R. 77.) With the exception of the hourly and daily workers, however, his hiring and firing of personnel was done strictly under the authority of his father and Golden. (R. 101-102.) During this period he was compensated at a rate beginning \$15 a week and reached \$35 per week in 1941. (R. 38, 78.) After January 1, 1942, the effective date of the alleged "partnership", he continued to work for Golden-Trepte and remained in the employ of Golden-Trepte during the greater part of the period from January 1, 1942, until October or November, 1943. (R. 78-79, 38.) Thus during the greater part of the taxable years involved, 1942 and 1943, Walter B. Trepte did not work directly for the partnership. From October or November, 1943, he worked for the partnership until the middle of 1944. Subsequently he worked for Golden-Trepte for four months, and has since worked for the partnership. (R. 79.) Any hiring or firing of employees subsequent to the formation of the partnership, with the exception of the hourly and daily workers, was also carried out only after discussion with his father. (R. 102, 38.) After the formation of the partnership, Walter B. Trepte's other duties were also largely under the direction and supervision of the taxpayer. (R. 143, 39.) Neither before nor after the formation of the partnership did Walter B. Trepte himself ever assemble the data necessary for the preparation and submission of a bid to the Government or anyone else. The testimony was somewhat vague in this respect, indicating that he had helped the estimators. (R. 38, 156-157.)

Thus it appears that the trial court's findings that the duties of Walter B. Trepte were not "vital" and were adequately compensated for by the payment of salary are supported by the record. There is entirely

lacking here that "mutual investment of capital and services" necessary for the effective creation of a family partnership for federal revenue purposes. *Mead v. Commissioner*, 131 F. 2d 323, 324 (C. A. 5th), certiorari denied, 318 U. S. 777.

Taxpayer concedes that the sons were merely employees of their father up until January 1, 1942, but argues that this was changed after they signed promissory notes and agreed to share the losses and profits. (Br. 34.) It is hardly necessary to note the unrealistic nature of this contention. There is nothing in the record to indicate that the sons had any property apart from their salaries from the business. This being so, their assumption of liability would appear to be highly fictional. Taxpayer's further statements (Br. 34, 35) that it was the skill of the father, and his two sons "that brought about the success of the Trepte Construction Co." and that "the services of the two sons were valuable and vital to the operations" border on the ridiculous. The business involved millions of dollars at the time of the formation of the partnership. There is not an iota of evidence to indicate that the business was increased by virtue of the sons' activities. Neither son brought any new capital into the business. The younger son worked for taxpayer only a few months in total during the taxable years. The older son never assumed a vital role in the conduct of the business, nor was he equipped to do so. As might be expected, taxpayer attempted at the trial, and attempts on appeal, to exalt the duties of his older son to a status of more influence and dignity than they warrant. Taxpayer, in effect, argues as if this Court were free to draw its own inferences, without regard to the findings of the Tax Court. The courts have been in unanimous agreement with the proposition reiterated in *Eisenberg v. Commissioner*,

161 F. 2d 506 (C. A. 3d), certiorari denied, 332 U. S. 767, as follows (p. 510):

Little can be accomplished toward ultimate determination of the tax responsibility, at least in this class of cases, by ferreting out analogous parts of other cases, particularly since "no one fact is decisive". It is well-settled that the Tax Court's determination, if supported by the facts, is conclusive. That we would not be inclined to draw the same conclusions or make the same inferences is of no significance whatever.

Apart from the failure of the taxpayer's sons to contribute either capital or vital services, an examination of the other evidence in this case gives cumulative proof of the lack of reality in the purported partnership. The record demonstrates that taxpayer continued to control the business operations, its assets and profits, after the formation of the partnership as well as before. Under the partnership agreement (Ex. 1, p. 3), taxpayer was made the general manager of the business. A reading of the record in its entirety discloses that taxpayer continued to dominate the business subsequent to the partnership agreement, as he had prior thereto. Taxpayer testified that he carried on his business before and after the formation of the partnership in the same way. (R. 165.) Most important, however, is the fact that under the partnership agreement taxpayer retained the same absolute control of all phases of the business as he had when the business was operated as a sole proprietorship and its assets owned in community by the taxpayer and his wife. The taxpayer and his wife had each retained a 26 percent interest in the partnership. (Ex. 1, p. 3.) Under the partnership agreement (R. 36) it was provided that "all profits arising from the operation of said partnership shall be added to the capital of said partnership so long as such a

majority interest so decides or in the discretion of the holders of a majority interest may be distributed * * *.” Thus taxpayer and his wife could absolutely preclude the distribution of any profits to their two sons, while at the same time drawing from the business as much as they desired for themselves in salary. In this connection, it should be noted the taxpayer received \$20,000 a year salary during the years 1942, 1943, 1945 and 1946. (R. 41.) The partnership agreement further provided that inventories of assets could be certified only by a partner delegated by partners holding a majority interest (Ex. 1, p. 4); that on dissolution an accounting should be taken which, when signed by the holders of the majority interest, would be conclusive (Ex. 1, p. 4); that checks could be drawn only by such partners and their agents who were delegated by the holders of a majority interest (Ex. 1, p. 5); that no partner could become bail or security for any person without the consent of partners holding a majority interest (Ex. 1, p. 5); that no partner could, without the consent of the partners holding a majority interest, loan any money or property of the partnership, accept or sign any bill of exchange or promissory note, buy or contract to buy any goods or merchandise, contract any debt on account of the partnership, or employ any of the partnership monies, or in any manner pledge the security thereof (Ex. 1, p. 5); and that on dissolution, the value set on the personal property should be that fixed by the holders of the majority interest (Ex. 1, p. 7). The partnership agreement also provided for limited restrictions on alienability, setting forth that the selling partner must first offer his interest to the other partners, and granting the other partners the option to purchase the share at the value fixed under the terms of the partnership agreement within

thirty days of the determination of the value as provided.

A mere reading of the partnership agreement suffices to demonstrate that the taxpayer never parted with any control over the business, its assets and the profits. In view of the taxpayer's wife's testimony that she left everything to her husband's best judgment (R. 120), it could not be reasonably anticipated that she would refuse to accede to any of his decisions. In short, taxpayer's economic status remained unchanged despite the formation of the partnership. Not only did he continue to earn the income, but he continued to exercise command over it. In order that his economic freedom might not in any way be abridged, the partnership agreement, while restricting the right of any other partner to engage in a competing business, left taxpayer free to engage in any business he desired. (Ex. 1, pp. 5-6.) Were taxpayer to prevail in this case, the consequence would be that family heads, while continuing to enjoy substantially the same control and economic benefits, could divide up single tax earnings into numerous tax units "by the simple expedient of drawing up papers." *Commissioner v. Tower, supra*, p. 291. Moreover, it is of significance to note that during the entire period from 1942 to 1946 only insignificant sums were withdrawn from the business by taxpayer's sons. Although the sum of \$113,122.27 was added to the account of Walter B. Trepte, and \$113,122.26 to that of Albert Eugene Trepte during this period, the record indicates that the most Walter B. Trepte drew for his personal use was \$4,520.49 over the entire six-year period, and Albert Eugene Trepte withdrew \$2,912.91 over the same period. Apart from the payments on "Note and Interest", "Collector of Internal Revenue", and "Franchise Tax Commission" over the six-year period \$2,680 was indicated as "Checks drawn

to Walter B. Trepte" and \$1,840.49 as "Checks drawn for Walter B. Trepte". As for Albert Eugene Trepte, \$2,000 was indicated as "Checks drawn to Albert Eugene Trepte", and \$912.91 as "Checks drawn for Albert Eugene Trepte". (R. 42-45, Exs. 13, 14.)

Also of some significance is the fact that although the partnership was allegedly established as of January 1, 1942, capital accounts were not set up for either son until March 31, 1943. The date first appearing on Albert Eugene Trepte's withdrawal account was March 27, 1943, and on Walter B. Trepte's withdrawal account was November 30, 1942. (R. 42-45, 49.) Taxpayer testified that the transition from his individual business to the partnership was gradual. (R. 134.) On the other hand, it may easily be perceived that unless the partnership was effectively created on January 1, 1942, under no view of the facts could the total income earned subsequently thereto constitute partnership income for federal revenue purposes.

Finally, as the Tax Court observed, the following paragraph of the partnership agreement would lend further support to the Commissioner's determination that the arrangement between taxpayer and his family was not intended as a partnership in the ordinary business sense. The paragraph reads as follows (R. 50, Ex. 1, p. 6):

That any and all earnings from personal services outside of this family co-partnership shall be given due consideration in allocating partnership profits and losses.

Taxpayer has argued that no tax avoidance scheme existed and consequently that the partnership was *bona fide*. Tax avoidance motives are not susceptible of easy proof and the record is not conclusive in this respect. It seems clear that taxpayer was at least aware of the tax consequences of the family partner-

ship. He testified that he was aware that the tax rates were going up, that he was reasonably familiar with the amount of taxes due on the earnings of his business, and that the passage of the two Revenue Acts of 1940 would normally have come to his attention. (R. 160-161.) A reading of the record at pages 166-167 demonstrates that the lower court was not satisfied with taxpayer's testimony as to the tax considerations in the formation of the family partnership. At one point, in answer to the court's instruction that he state the extent to which he took into consideration the matter of dividing up income in forming the partnership, taxpayer testified: "Well, I don't think we considered it particularly." (R. 167.) On further questioning, he stated that he did not consider the tax consequences at all. Taxpayer stated that the purpose in forming the partnership was so that his sons could "carry on in the case of my death." (R. 167.) Yet his wife had testified that taxpayer was the only one equipped to carry on the business. (R. 118.) Also, taxpayer himself had conceded that his younger son could not carry on the business. (R. 156.) The record would further indicate that the older son was neither educationally nor technically equipped to do so. At any rate, the existence of a tax avoidance motive is in no sense determinative but "simply lends further support to the inference * * * that no partnership right exists." *Commissioner v. Tower, supra*, p. 289.

Taxpayer has attempted to ferret out analogous portions of other partnership cases which have been decided for taxpayers. As previously indicated, such an approach can avail little, since each case is dependent upon its own facts and the appellate court's function is limited to an inquiry as to whether the Tax Court's determination of the *bona fides* of the partnership arrangement is clearly erroneous. In placing his

chief reliance on *Culbertson v. Commissioner*, 168 F. 2d 979 (C. A. 5th), certiorari granted December 6, 1948, taxpayer relies on what is perhaps the most extreme decision rendered in recent years by an appellate court in the field of family partnerships. The *Culbertson* case is on its face not only inconsistent with the United States Supreme Court's holdings in the *Tower* and *Lusthaus* cases, and with a legion of appellate decisions in every Circuit,¹ but marks a radical departure from the approach taken by the Court of Appeals for the

¹ See, e.g., Ninth Circuit: *Nordling v. Commissioner*, 166 F. 2d 703, certiorari denied, 335 U. S. 817; *Quon v. Commissioner*, 165 F. 2d 215, certiorari denied, 334 U. S. 845. Second Circuit: *Seifert v. Commissioner*, 157 F. 2d 719; *Seibert v. Commissioner*, 156 F. 2d 227; *Miller v. Commissioner*, 150 F. 2d 823; *Waldburger v. Helvering*, 131 F. 2d 598; *Fletcher v. Commissioner*, 164 F. 2d 182, certiorari denied, 333 U. S. 855. Third Circuit: *Eisenberg v. Commissioner*, 161 F. 2d 506, certiorari denied, 332 U. S. 767; *Davis v. Commissioner*, 161 F. 2d 361; *Walker v. Commissioner*, 160 F. 2d 313; *Lusthaus v. Commissioner*, 149 F. 2d 232, affirmed, 327 U. S. 293; *Sweigard v. Commissioner*, 149 F. 2d 646. Fourth Circuit: *Wilson v. Commissioner*, 161 F. 2d 556, certiorari denied, 332 U. S. 769; *Mauldin v. Commissioner*, 155 F. 2d 666; *Hash v. Commissioner*, 152 F. 2d 722, certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Economos v. Commissioner*, 167 F. 2d 165, certiorari denied, 335 U. S. 826. Sixth Circuit: *Hougland v. Commissioner*, 166 F. 2d 815, certiorari denied, 334 U. S. 846; *Dawson v. Commissioner*, 163 F. 2d 664; *Lowry v. Commissioner*, 154 F. 2d 448, certiorari denied, 329 U. S. 725; *Lorenz v. Commissioner*, 148 F. 2d 527, certiorari denied, 327 U. S. 786; *Thorrez v. Commissioner*, 155 F. 2d 791; *Camfield v. Commissioner*, 154 F. 2d 1016; *Livie v. Commissioner*, 155 F. 2d 728; *Ewing v. Commissioner*, 157 F. 2d 679; *DeKorse v. Commissioner*, 158 F. 2d 801; *Greenberg v. Commissioner*, 158 F. 2d 800; *Schreiber v. Commissioner*, 160 F. 2d 108; *MacDonald v. Commissioner*, 165 F. 2d 213; *Epps v. Commissioner*, 164 F. 2d 482; cf. *Weinstein v. Commissioner*, 166 F. 2d 81. Seventh Circuit: *Appel v. Smith*, 161 F. 2d 121; *Tinkoff v. Commissioner*, 120 F. 2d 564. Eighth Circuit: *Doll v. Commissioner*, 149 F. 2d 239, certiorari denied, 326 U. S. 725; *Supornick v. Commissioner*, 150 F. 2d 110; *Tyson v. Commissioner*, 146 F. 2d 50. Tenth Circuit: *Earp v. Jones*, 131 F. 2d 292, certiorari denied, 318 U. S. 764; *Grant v. Commissioner*, 150 F. 2d 915; *Bradshaw v. Commissioner*, 150 F. 2d 918; *Losh v. Commissioner*, 145 F. 2d 456.

Fifth Circuit itself.² Insofar as the decision in the *Culbertson* case was premised on the theory that a "legal" sale was consummated, the consideration being the execution of notes to be paid out of the business earnings, the court adopted a formalistic approach, specifically rejected in the *Lusthaus* case, and indeed on its facts in the teeth of the *Lusthaus* case. Insofar as the decision rests on the theory that the partnership may be effective, even though the services are to be rendered subsequent to the taxable years involved, the Court overlooked the underlying basis of the *Tower* and *Lusthaus* decisions, which is to tax the income to its earner. That the alleged partner might some time in the future render vital services has little bearing on the question as to who was the creative source of the income during the taxable years involved. Insofar as the decision was premised on the theory that the contribution of service to the United States Armed Forces by one who was not prior thereto a partner in the tax sense is sufficient to dispense with the requirement of "vital additional services", it can be supported by no rational argument; for obviously war service cannot create a partnership among private individuals. Insofar as the decision ignores the determination of the Tax Court, which was overwhelmingly supported by the evidence, it was based upon an apparently erroneous concept as to the scope of the appellate court's review. It is undoubtedly for these reasons that the

² *Scherf v. Commissioner*, 161 F. 2d 495, certiorari denied, 332 U. S. 810; *Benson v. Commissioner*, 161 F. 2d 821; *Belcher v. Commissioner*, 162 F. 2d 974, certiorari denied, 332 U. S. 824; *Mead v. Commissioner*, 131 F. 2d 323, certiorari denied, 318 U. S. 777; *Argo v. Commissioner*, 150 F. 2d 67, certiorari denied, 326 U. S. 762; *Sewell's Estate v. Commissioner*, 151 F. 2d 806, certiorari denied, 327 U. S. 805; *Sewell v. Commissioner*, 151 F. 2d 765, certiorari denied, 327 U. S. 783; *Daves v. Allen*, 157 F. 2d 518; *Blalock v. Allen*, 151 F. 2d 927; *Morton v. Thomas*, 158 F. 2d 574, certiorari denied, 330 U. S. 834.

United States Supreme Court granted certiorari from the decision in the *Culbertson* case on December 6, 1948.

II

Taxpayer's Attempted Assignment to the Partnership of His Interest in the Joint Venture Known as Golden-Trepte Construction Company, Whose Assets Consisted of Government Construction Contracts, Was Ineffective for Tax Purposes

The Commissioner determined, not only that the partnership was ineffective for federal revenue purposes, but, alternatively, that the assignment to it by taxpayer of his interest in the Golden-Trepte contracts was ineffective. Since the Tax Court decided for the Commissioner on the first issue, it found it unnecessary to consider the second, the income being taxable to taxpayer and his wife under either theory. Inasmuch as the Tax Court made no determination of this issue, and inasmuch as its decision on the first issue is not subject to serious attack on appeal, no extensive treatment of the latter problem is here undertaken. However, the Commissioner firmly believes in the validity of the alternative determination. An examination of the various contracts demonstrates that in essence they were cost-plus-fixed-fee contracts. (Exs. K, L.) The contracts were signed by no one but taxpayer and Golden. No one was liable on the contracts except taxpayer and Golden. There can be no question, on the record, but that they were awarded on the basis of taxpayer's personal reputation for integrity and competence as an engineer. The work required the personal service and supervision of the contractors. Cf. *Wittenberg v. Commissioner*, decided December 13, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,293). The authority is overwhelmingly to the effect that the attempted assignment of past or future income flowing from the personal skill and services of the tax-

payer is ineffective for tax purposes. *Lucas v. Earl*, 281 U. S. 111; *Earp v. Jones*, 131 F. 2d 292 (C. A. 10th), certiorari denied, 318 U. S. 764; *Burnet v. Leininger*, 285 U. S. 136.

CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,

A. F. PRESCOTT,

SUMNER M. REDSTONE,

Special Assistants to the Attorney General.

FEBRUARY, 1949.



IN THE
United States
Court of Appeals
For the Ninth Circuit

WALTER TREPTE and MARGARET TREPTE,
Petitioners,

v.

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Respondent.

**ON PETITION FOR REVIEW OF THE
DECISIONS OF THE TAX COURT
OF THE UNITED STATES**

REPLY BRIEF FOR THE PETITIONERS

GEORGE H. STONE,

1004 San Diego Trust & Savings Building,
San Diego 1, California,

Counsel for Petitioners.

WM. D. MORRISON,

821 First National Bank Building,
San Diego 1, California,

Counsel for Petitioners.

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**IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

No. 12078

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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**ON PETITION FOR REVIEW OF THE
DECISIONS OF THE TAX COURT
OF THE UNITED STATES**

BRIEF FOR THE PETITIONERS

Opinion of the Tax Court

The memorandum findings of fact and opinion of the Tax Court of the United States (Tr. 28-51) are not officially reported.

Jurisdiction

This petition for review (Tr. 54-64) involves United States income and victory taxes for the calendar years 1942 and 1943. On August 23, 1946, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiencies in the total amounts as follows:

	Years	Amount
Walter Trepte	1942-1943	\$23,183.84 (Tr. 4)
Margaret Trepte....	1942-1943	\$29,480.82 (Tr. 16)

Within ninety days thereafter and on November 18, 1946, the taxpayers filed their petitions with the Tax Court of the United States for a redetermination of those deficiencies under the provisions of Section 272 of the Internal Revenue Code. (Tr. 4-26.) The decisions of the Tax Court sustaining the deficiencies were entered May 28, 1948. (Tr. 52, 53.) The case is brought to this Court by a petition for review filed August 23, 1948 (Tr. 54-64), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Questions Involved

The questions involved are the same as set out in Brief for Petitioners, pages 2 and 3.

Statement

Petitioners briefly set out herein the most noticeable errors contained in the Summary of Argument and Argument presented in the brief for the Respondent.

Summary of Argument

THE SUMMARY OF ARGUMENT OF RESPONDENT IN HIS BRIEF IS SO ERRONEOUS WE FEEL IT IS NECESSARY TO CALL CERTAIN ITEMS THEREIN TO THE COURT'S ATTENTION. (RESP. BR. 16.)

Contrary to the Summary of Argument of the Respondent the entire Record supports the contention of the Petitioners that the Trepte Construction Co. co-partnership was entered into and carried on in good faith, it was actual, real and bona fide, and entered into for the benefit of the co-partners with no thought of income taxes and with no purpose of dividing the family income to avoid, divide or defeat income taxes.

Walter B. Trepte worked diligently for his father, Walter Trepte, prior to January 1, 1942, the date of the formation of the co-partnership and worked steadily for the co-partnership during the taxable years involved and to date; whereas, Albert Eugene Trepte worked for his father prior to the formation of the co-partnership, January 1, 1942, but did not work steadily for the co-partnership during the taxable years involved or subsequent thereto, as his services for the co-partnership were interrupted while at school and during the period he was in the armed forces of the United States.

In spite of the fact that the Respondent constantly belittles the services of the two sons, one of the Petitioners herein, Walter Trepte, the father of the two sons, his associates, and officers in the armed forces of the United States as shown by the Record, were undoubtedly in a better position to gauge or determine the value of the services of each of the sons than one who is attempting to do so without actually seeing the vital and valuable services which were rendered. And further it is difficult to understand why the Respondent should underrate the services of Walter B. Trepte who was at various times Personnel Manager, Office Manager, representative for the co-partnership on numerous jobs, and assistant to his father in the operation of the co-partnership. At this time, after more than seven years have passed, the said sons, Walter B. Trepte and Albert Eugene Trepte, are still rendering vital and valuable services and each taking his share of the responsibility in the management and operation of the said co-partnership of which each is still a member. And to state that the services of Albert Eugene Trepte were negligible is grossly inconsistent with the Record, as the evidence shows that his services were vital and valuable. The responsibility placed on

the shoulders of Albert Eugene Trepte while serving in the United States Navy speaks for itself as to his ability.

The Respondent's Summary of Argument further states that the taxpayer, apparently meaning Walter Trepte, dominated the business subsequent to the formation of the co-partnership and exercised extensive control over the profits, assets, and every phase of the business operations and his economic status was unchanged, all of which is not in accord with the facts as set out in the Record, and further, Respondent overlooked the fact that when Walter Trepte's wife, Margaret Trepte became a co-partner in the business her share of the income from and after January 1, 1942 was obtained from the operations of the co-partnership instead of one-half of the community earnings of Walter Trepte.

The Respondent grossly erred wherein he stated: "Since the determination of the Tax Court that the partnership was not bona fide for federal revenue purposes is patently not clearly erroneous, it may not be disturbed on appeal", as this situation was changed by the removal of all traces of the Dobson decision (*Dobson v. Commissioner*, 320 U.S. 489, 88 L. Ed. 248, 64 S. Ct. 239), 1949 P-H Par. 21,820.

The last paragraph of the Summary of Argument of the Respondent is definitely misleading (Resp. Br. 16) as the Tax Court merely stated, "In view of our conclusion it becomes unnecessary to consider the second issue." (R. 51.)

Argument

I

THE RECORD DOES NOT SUPPORT IN ANY WAY THE DETERMINATION OF THE TAX COURT THAT THE FAMILY CO-PARTNERSHIP ESTABLISHED BY THE TAXPAYERS AND THEIR CHILDREN IS NOT BONA FIDE FOR FEDERAL REVENUE PURPOSES. THE RECORD CLEARLY SUPPORTS THE FACT THAT IT WAS A REAL, ACTUAL, LEGAL, VALID AND BONA FIDE CO-PARTNERSHIP FOR ALL PURPOSES.

Contrary to the statement of Respondent, the incoming partners, Walter B. Trepte and Albert Eugene Trepte, each invested capital originating with them, each rendered vital and valuable services, and each substantially contributed to the control and management of the business and did all things necessary and requisite to constitute a real, actual, legal, valid and bona fide co-partnership. (Resp. Br. 17.)

The Petitioners respectfully submit that so far as the *Commissioner v. Tower*, 327 U.S. 280, 290; *Lusthaus v. Commissioner*, 327 U.S. 293, are concerned all things were done to come within a bona fide partnership under rules set out in these two decisions. The control of the co-partnership business was in the four co-partners, and the profits were distributed to the said co-partners. The alienability of the partnership interests, and the motives leading to the formation of the partnership were the most honorable. It is a fundamental principle of law that a partnership agreement may provide for the alienability of interest or it may be dissolved by mutual consent or

an accounting had and the business of the partnership wound up. As to the motives, there can be none more honorable than that of a father and a mother to admit as members of a co-partnership their sons as was done in this case. The RECORD shows that the good will and integrity of the TREPTE name in the contracting and building trade has continued for nearly half a century, which distinctly and definitely shows co-operation and co-ordination in the family unit.

The *Belcher v. Commissioner*, 162 F. 2d 974 (C.A. 5th) (Decided 7-2-47) is not in point with the facts in the instant case. In the case cited, the family partnership consisted of Belcher, his wife as trustee for four minor children, and individually, and the trusts were created by the taxpayer, without contribution of capital or services by members of the family, except the wife who rendered only nominal services.

The *Nordling v. Commissioner*, 166 2d 703 (C. A. 9th) can readily be distinguished from the case before this Court. It was a husband and wife partnership and was not recognized for the reason that the wife's interest was purchased by her husband from his brother, a retiring partner. She later contributed only nominal services to the business.

As to the *Blalock v. Allen*, 151 F. 2d 927 (C. A. 5th) (Decided 12-3-45), the facts in this case have no similarity to the case now before this Court. A. O. Blalock, the father, 79 years of age, was made senior partner with no powers in the partnership affairs—he died in 1944.

Both, the *Nordling* case and the *Blalock* case were decided before the *Dobson* case ruling of the Supreme Court in 1943 was outlawed by Section 36, Public Law 773—80th Congress, 2nd session, approved June 25,

1948, effective September 1, 1948. (Resp. Br. 17 and 18.) (See 1949 P-H Par. 21,820.)

It is grossly unfair to state as the Respondent did in the first full paragraph of page 19 of his brief, that neither son rendered vital services to the business: "It is equally manifest that, as the Tax Court found (R. 48), neither son rendered vital additional services to the business. The most cursory analysis of the record suffices to demonstrate that the services rendered by Albert Eugene Trepte, who was sixteen years old at the time of the formation of the partnership, were negligible." Contrary to this statement, Walter B. Trepte was at various times Personnel Manager, Office Manager, representative for the co-partnership on numerous jobs and was fully recognized as assistant in every way to his father, one of the Petitioners herein. Albert Eugene Trepte was past the age of sixteen years and there is no doubt but that the father of the two sons, his associates, and officers of the armed forces of the United States were in a better position to judge and determine the vital and valuable services rendered by his two sons than one who only made a most CURSORY ANALYSIS of the records. Further, subsequent to the formation of the partnership the responsibility assigned to Albert Eugene Trepte while he was in the United States Navy would certainly indicate that the son had outstanding ability and for that reason it is difficult to understand why it is stated that his services were negligible. (Resp. Br. 19.)

The Respondent stated, "Thus during the greater part of the taxable years involved, 1942 and 1943, Walter B. Trepte did not work directly for the partnership". This statement is completely erroneous for the reason that during the years involved, namely, 1942 and 1943, Walter B. Trepte did work directly and diligently for

the co-partnership. Any compensation he received on any of the jobs upon which he was the representative of the co-partnership or otherwise, was either charged to him or the amount which he received was turned over to the co-partnership by him.

A very loose examination of the case of *Mead v. Commissioner*, 131 F. 2d 323, 324 (C. A. 5th) would disclose that it had no facts similar to those in the case now being considered as Mr. Mead personally withdrew most of the income. For 1937, the income was \$10,504.21, he withdrew \$9,771.61; for 1938, the income was \$13,485.60, he withdrew \$12,707.04; Mrs. Mead had no drawing account, took no part in the management or conduct of the business, made no contribution of capital, and no actual distribution of the partnership income was ever made. (Cited, Resp. Br. 22.)

In the middle of page 22, Respondent's Brief, he states: "The business involved millions of dollars at the time of the formation of the partnership. There is not an iota of evidence to indicate that the business was increased by virtue of the sons' activities."

It is true that the business involved millions; in fact, one job, NOY 4205, was approximately twenty-one millions of dollars. (R. 148.) There was no necessity for increasing the business, as the partnership had all it could handle at that time and that was one of the outstanding reasons why Walter Trepte Builder was anxious to form a co-partnership with his two sons as partners so they could assist him to carry on the business which was growing by leaps and bounds. It was necessary that he have persons around him in whom he could place implicit confidence and trust, and his two sons were the proper persons, as from childhood they had worked with their father, knew and understood much about the business.

The last sentence on page 22, Respondent's Brief, states: "Taxpayer, in effect, argues as if this Court were free to draw its own inferences without regard to findings of the Tax Court." The taxpayers still contend that this Court is free to draw its own inferences without regard to the findings of the Tax Court, and as authority for the petitioners' contention, cite H. R. 3214, which became Section 36, Public Law 773—80th Congress, 2nd session, approved June 25, 1948, effective September 1, 1948, which is also designated I. R. C. 1141, and reads as follows, to wit:

"Courts of Review. (a) Jurisdiction.—The circuit courts of appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in Civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code."

The Respondent has conveniently overlooked the fact that I. R. C. 1141 removes all traces of the Dobson decision which originated in 1943, *Dobson v. Commissioner*, 320 U. S. 489, 88 L. Ed. 248, 64 S. Ct. 239. The Dobson decision, in effect, held that where the elements of a decision could not be separated so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand.

The new provision, Sec. 1141, is applicable to all decisions pending before the appellate court on September

1, 1948. In substance, all decisions prior to September 1, 1948 in which a Tax Court case was held to be final under the Dobson Rule, are now of practically no value as precedents. Some of those cases, no doubt, would be decided in the same way but for a different reason. It is quite evident that the Dobson Rule was so stringent and unjust that it was necessary for Congress to pass a law to remove all traces of the Dobson decision. (See 1949 P-H, Par. 21,820.)

The *Eisenberg v. Commissioner*, 161 F. 2d 506 (C. A. 3rd) case cited at bottom of Respondent's Brief, page 22, is not applicable to the instant case as it involves separate trusts for minor children and made the several trusts members of the partnership and the trustor retained dominion and control over the corpus of the trust. This is another case which falls within the Dobson rule as discussed supra.

The first full sentence at the top of page 24 of Respondent's Brief which reads, "Thus taxpayer and his wife could absolutely preclude the distribution of any profits to their two sons, while at the same time drawing from the business as much as they desired for themselves in salary", is rather an idle gesture on the part of the Respondent as he completely overlooked the fact that Margaret Trepte and her two sons who constitute the holders of a majority interest, could if they so desired, control whatever conditions or circumstances that may arise.

The first sentence in the first paragraph at top of page 25 of Respondent's Brief, which reads, "A mere reading of the partnership agreement suffices to demonstrate that the taxpayer never parted with any control over the business, its assets and the profits", does not only border on the ridiculous but is utterly ridiculous, as on the same

page, Respondent makes the statement, "Moreover, it is of significance to note that during the entire period from 1942 to 1946 only insignificant sums were withdrawn from the business by taxpayer's sons", and then makes a statement that the sum of \$113,122.27 was added to the account of Walter B. Trepte and \$113,122.26 was added to the account of Albert Eugene Trepte during this period, and in this connection, we respectfully refer to Brief for Petitioners, page 10, SUMMARY, which shows and is substantiated by the original book account of which a photostat copy is in evidence (Exhibits 13 and 15) that Walter B. Trepte's partnership share of income during the years 1942 to 1946 was \$129,583.24, his withdrawals were \$97,018.38, and to his original capital on January 1, 1942 in the sum of \$29,941.17 which represents the purchase price of his interest in and to the Trepte Construction Co. co-partnership, there was added during the period 1942 to 1946, inclusive, \$32,564.86, which brought his capital up to the figure, December 31, 1946, of \$62,506.03, and Brief for Petitioners, bottom of page 12, SUMMARY, of the original book account of Albert Eugene Trepte, a photostat copy of which is in evidence (Petitioner's Exhibits 14 and 16) shows that during the said period his partnership share of income amounted to \$112,122.26 and his withdrawals \$74,153.89, his capital on January 1, 1942 was \$29,941.17, which was the purchase price of his interest in and to the Trepte Construction Co. co-partnership, to which there was added during the years 1942 to 1946, inclusive, the sum of \$37,968.37 and his capital at the close of the year 1946 was \$67,909.54. It is indeed difficult to comprehend why the Respondent should refer to the withdrawals of the two sons, Walter B. Trepte and Albert Eugene Trepte, as only insignificant

sums, when the former withdrew during the period 1942 to 1946, inclusive, \$97,018.38 and the latter, \$74,153.89.

(Note: Through some oversight the headings in connection with the Summary of Exhibit 13, page 7, of Petitioners' Brief are incorrectly placed above the proper column of figures. The headings should be placed as shown in connection with the Summary of Exhibit 14, page 8, of the said Brief.)

Respondent's Brief, page 26, first paragraph, third sentence, states, "Taxpayer testified that the transition from his individual business to the partnership was gradual. (R. 134)." Such a statement gives the wrong understanding to the testimony of the taxpayer. He did testify to the fact that the transition was gradual in that they did not immediately print new stationery or have new checks printed, but did have rubber stamps made to overstamp checks and letterheads that were already printed. The Trepte Construction Co. co-partnership was created on January 1, 1942 and from that date the business was so conducted and recognized.

Apparently the Respondent fails to recognize the doctrine of "*pari materia*", for the reason that on page 26, the second full sentence of his brief with the excerpt from the contract which reads: "Finally, as the Tax Court observed, the following paragraph of the partnership agreement would lend further support to the Commissioner's determination that the arrangement between taxpayer and his family was not intended as a partnership in the ordinary business sense. The paragraph reads as follows (R. 50, Ex. 1, p. 6):

That any and all earnings from personal services outside of this family co-partnership shall be given

due consideration in allocating partnership profits and losses",

does not give consideration to the remainder of Article 11 of the Articles of Co-partnership, and when the said paragraph is construed as a unit, it simply means that whatever earnings any co-partner shall have outside of the said co-partnership shall be given consideration before allocating compensation or remuneration to the co-partner for his services, in addition to his share or interest in and to the profits or losses of the said co-partnership.

Petitioners seriously object to the misstatement and a misconstruction of the testimony of Walter Treppe as set out on page 27 of Respondent's Brief, second sentence, which reads, "A reading of the record at pages 166-167 demonstrates that the lower court was not satisfied with taxpayer's testimony as to the tax considerations in the formation of the family partnership. At one point, in answer to the court's instruction that he state the extent to which he took into consideration the matter of dividing up income in forming the partnership, taxpayer testified: 'Well, I don't think we considered it particularly.' (R. 167)". We believe that the words, "court's instruction" were intended to be "court's interrogation", and further, Counsel for the Commissioner repeatedly attempted to obtain the answer which he desired, but was unable to do so, subsequently and just before the end of the hearing, the Court interrogated the witness, and we quote in this respect from page 167 of the Transcript of Record:

"The Court: State to what extent, if any, you took into consideration the matter of dividing up income by forming a partnership arrangement?

"The Witness: Well, I don't think we considered it particularly. The main thing was to have

the boys in the business, to carry on in the case of my death.

“The Court: You say you don’t think you considered it particularly. That is rather a general answer. Tell me more particularly about that, whether you did or did not.

“The Witness: We did not.”

In the last paragraph of page 27 of Respondent’s Brief, he is again attempting to instruct this Court regarding its duties in the case now before the Court, but has not given due or proper consideration to the fact that the Dobson Rule became ineffective on September 1, 1948. (See 1949 P-H, Par. 21,820.)

On page 28 of Respondent’s Brief he attempts to discredit the case of *Culbertson v. Commissioner*, 168 Fed. 2d 979 (C. A. 5th), and points out what he believes to be inconsistencies between its holdings and the U. S. Supreme Court’s holdings in the *Tower* and *Lusthaus* cases supra, whereas if one studied the cases diligently he would no doubt find that they were not inconsistent and it was so determined by the learned judges of the 5th Circuit who gave mature and cautious consideration to the *Tower* and *Lusthaus* cases when deciding the *Culbertson* case.

After extensive study of decisions by the Tax Court of the United States in connection with family partnership cases, one must reach the conclusion that every time a family partnership case appears on the horizon, it will, by the Tax Court, most generally be decided against the petitioner, which no doubt was the reason for Congress to enact Public Law 773—80th Congress, 2nd session, which became effective September 1, 1948. Various tax services and tax letters often refer to the trend toward

more favorable treatment of family partnerships, the most recent of which stated in connection with bills to benefit taxpayers, "Family partnerships would be recognized if valid under the State laws." This trend is particularly noticeable in cases such as this one where the co-partnership consists of other members of the family rendering vital and valuable services than husband or wife only, as was the situation in both the Tower and Lusthaus cases.

As for the long list of cases set out as footnotes on pages 28 and 29 of Respondent's Brief, they were all decided prior to Sec. 36, Public Law 773—80th Congress, 2nd session, therefore, they are not applicable to the case now before this Court and further, in each and every instance the cases cited by Respondent, some fifty of them, are all distinguishable from the case now before this Court.

An examination of the cases cited shows that in most instances they come within the husband and wife category or a trust which is considered a member of the partnership wherein minor children are involved, or a mere assignment of income has been made and none of the said cases possess the facts as does the instant one wherein the sons contributed capital, rendered valuable and vital services, assumed responsibility, accepted their full share of the management and control of the operations of the business, were given their full division of the profits obtained through the operation of the business, and having had a family tradition in the operation of the same business for approximately a half of a century.

It is only natural that the Respondent should be so agreeable in accepting the MEMORANDUM FINDINGS OF FACT AND OPINION of the Tax Court of the United States as it is altogether in his favor, al-

though Petitioner contends that the Memorandum Findings of Fact and Opinion neither follow the fact nor the law. It should not be overlooked that the Tax Court of the United States and the Commissioner of Internal Revenue are both agencies of the executive branch of the Government.

Argument

II

On Page 30, Respondent's Brief, he makes the following statement:

"TAXPAYER'S ATTEMPTED ASSIGNMENT TO THE PARTNERSHIP OF HIS INTEREST IN THE JOINT VENTURE KNOWN AS GOLDEN - TREPTE CONSTRUCTION COMPANY, WHOSE ASSETS CONSISTED OF GOVERNMENT CONSTRUCTION CONTRACTS, WAS INEFFECTIVE FOR TAX PURPOSES",

but does not support his statement with any applicable authorities.

As for the Wittenberg v. Commissioner case, decided December 13, 1944 (1944 P-H T. C. Memorandum Decision, Par. 44,293), it was partnership income which was assigned to the family trust. The taxpayer created three trusts for his three minor children to which he assigned a one-third interest in a partnership of which he was a member. The powers under the partnership agreement presented substantial doubt as to the freedom of the trust property from his dominion or control. It was obvious that neither the wife nor the children of the petitioner rendered any services. This case differs from the case now before this Court in that the Wittenberg case was strictly an assignment of income, whereas in the instant case it was an assignment of property.

The Lucas v. Earl, 281 U. S. 111; Earp v. Jones, 131 F. 2d 292; and Burnet v. Leininger, 285 U. S. 136, are readily distinguishable from the case being considered. In the Lucas case, husband and wife entered into a contract whereby they agreed that whatever each had or acquired in any way during the existence of the marriage should be received and owned by them as joint tenants. In the Earp case, the husband made a gift of a one-half interest in his business to his wife and a partnership agreement between his wife and himself was subsequently effected. The Burnet case was merely an equitable assignment on the part of Mr. Leininger to his wife of one-half of what he should receive from the partnership in which he was a member and an agreement by her to make good to him one-half of the losses he might sustain by reason of his interest in the partnership. As stated before, in the case now before this Court, the assignment was of property or a right to carry on the operations of the business, and not an assignment of income. Such action is supported, approved and allowed in the case of Iowa Bridge Co. v. Commissioner, 29 F 2d page 777.

Conclusion

The decision of the Tax Court of the United States should be reversed.

Respectfully submitted,

GEORGE H. STONE,
1004 San Diego Trust & Savings Building,
San Diego 1, California.

WM. D. MORRISON,
821 First National Bank Building,
San Diego 1, California.

Counsel for Petitioners.

No. 12079

United States
Court of Appeals

for the Ninth Circuit

WILSHIRE & WESTERN SANDWICHES,
INC., a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

FILED
DEC 1 1948

PAUL P. O'BRIEN,

CLERK



No. 12079

United States
Court of Appeals
for the Ninth Circuit

WILSHIRE & WESTERN SANDWICHES,
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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—direct 226

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APPEARANCES

For Petitioner:

HENRY M. WEBSTER, C.P.A.,
MARTIN H. WEBSTER, Esq.,
PAUL ZIFFREN, Esq.,
JACOB SHEARER, Esq.

For Respondents:

R. E. MAIDEN, Esq.,
E. C. CROUTER, Esq.

Docket No. 10638

WILSHIRE & WESTERN SANDWICHES,
INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1946

Apr. 24—Petition received and filed. Taxpayer notified. Fee paid.

Apr. 25—Copy of petition served on General Counsel.

May 29—Answer filed by General Counsel.

May 29—Request for hearing in Los Angeles, California filed by General Counsel.

1946

June 3—Notice issued placing proceeding on Los Angeles, California calendar. Service of answer and request made.

1947

July 31—Motion to change date of hearing to next calendar after September filed by taxpayer. Granted.

July 31—Hearing set 9/22/47 in Los Angeles, California.

Sept. 30—Hearing set 12/1/47 in Los Angeles, California.

Nov. 5—Appearance of Paul Ziffren and Jacob Shearer as counsel filed.

Dec. 3

& 4—Hearing had before Judge Disney on merits. Stipulation of facts filed.

Dec. 12—Hearing had before Judge Disney on merits. Motion of petitioner to amend petition to conform to the proof—Motion granted. Respondent to file amended answer within 15 days. This appeal tried at Los Angeles, Calif., December 3rd and 4th. See previous minutes. Motion to amend petition filed at hearing. Copies served. Briefs due 2/2/48. Reply briefs 2/25/48.

Dec. 19—Transcript of hearing 12/3/47 filed.

Dec. 19—Transcript of hearing 12/4/47 filed.

Dec. 26—Answer to amendment to petition filed by General Counsel. 12/29/47 Served.

1948

- Jan. 19—Deposition of Robert A. Odell filed. (1)
Served by notary.
- Jan. 20—Brief filed by taxpayer. 2/4/48 Copy
served.
- Feb. 3—Motion for leave to file the attached
brief, brief lodged, filed by General Coun-
sel. 2/4/48 Granted.
- Feb. 24—Motion for extension to 3/5/48 to file re-
ply brief, filed by taxpayer. 2/25/48
Granted as to both parties.
- Mar. 4—Reply brief filed by taxpayer. Copy
served.
- June 29—Memorandum findings of fact and opinion
rendered, Judge Disney. Decision will be
entered for the respondent. Copy served.
- June 29—Decision entered. Judge Disney. Div. 4.
- July 8—Transcript of hearing 12/12/47 filed.
- Sept. 20—Petition for review by U. S. Court of
Appeals for the Ninth Circuit, with as-
signments of error filed by taxpayer.
- Sept. 27—Proof of service filed.
- Oct. 1—Praecipe for record filed by taxpayer.
- Oct. 6—Designation of contents of record with
proof of service attached thereto, filed by
taxpayer.
- Oct. 7—Order re transmission of Joint Exhibits
8-H, 9-I and 10-J inclusive in physical
form to be transmitted with the appeal
record entered.

1948

- Oct. 8—Motion that Exhibits 11 to 31 inclusive remain in custody of the Clerk of The Tax Court until 15 days prior to trial and upon advice of counsel be transmitted to U. S. Court of Appeals for the Ninth Circuit in physical form, filed by General Counsel.
- Oct. 12—Order that Exhibits 11 to 31 inclusive remain in custody of the Clerk of The Tax Court until 15 days prior to trial and upon advice of counsel be transmitted to U. S. Court of Appeals for the 9th Circuit in physical form, entered. [2*]

The Tax Court of the United States

Docket No. 10638

WILSHIRE AND WESTERN SANDWICHES,
INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of

* Page numbering appearing at foot of page of original certified Transcript of Record.

deficiency (Bureau Symbols LA:IT:90D:PAK) dated January 31, 1946, and as a basis of its proceeding alleges as follows:

1. The petitioner is a California corporation with principal office at 3180 West Sixth Street, Los Angeles 5, California. The returns for the periods here involved were filed with the collector for the sixth district of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on January 31, 1946.

3. The taxes in controversy are income taxes for the calendar year 1942 in the amount of \$599.87 and for the calendar year 1943 in the amount of \$782.72; declared value excess profit tax for the calendar year 1943 in the amount of \$168.31; and excess profits taxes for the calendar year 1943 in the amount of \$1,797.05. [3]

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In determining the taxable net income of the petitioner for the calendar years 1942 and 1943, the Commissioner erroneously disallowed a deduction for interest accrued in the amount of \$1,500 for 1942 and \$1,443.36 for 1943.

(b) In determining the excess profits net income of the petitioner for the calendar year 1943, the Commissioner erroneously disallowed a deduction for interest accrued in the amount of \$1,443.36.

(c) In all of the aforesaid determinations, the

Commissioner has erroneously considered moneys advanced by stockholders of petitioner as capital contributions rather than as loans.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The original capitalization of petitioner was planned to and actually did consist of the issuance of 3,000 shares of capital stock at the par value of \$10.00 each, or a total of \$30,000 as capital contribution. Uncertainty existed at the time of incorporation as to exactly how much money would be needed by petitioner to erect the building in its business and to purchase the equipment required therefor, although it was thought that the \$30,000 capital would probably be sufficient. Accordingly, the incorporators of petitioner agreed to lend to petitioner such amounts of money as might additionally be required for these purposes, the loans to be repayable in two years, to bear interest at the rate of 6% per annum, and to be represented by promissory notes. Pursuant to such agreement, and upon it being learnt that [4] more than the original capital contribution of \$30,000 would be required to erect the building and install the equipment, some but not all of the stockholders of petitioner lent sums of money to petitioner aggregating \$25,000. All such loans were evidenced by promissory notes, were payable in two years, and bore interest at 6% per annum. Interest was in fact accrued and paid on these notes, the books of petitioner recorded the interest as an expense, and the advances to it by its stockholders as loans. The Commissioner has erro-

neously considered these loans as in fact capital contributions.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine the deficiency due from the petitioner.

/s/ HENRY M. WEBSTER,

/s/ MARTIN H. WEBSTER,
Counsel for Petitioner.

State of California,
County of Los Angeles—ss:

Harry B. Carpenter, being duly sworn, says that he is President of petitioner corporation, that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had the same read to him, and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be on information and belief, and that those he believes to be true.

/s/ HARRY B. CARPENTER.

Subscribed and sworn to before me this 22nd day of April, 1946.

/s/ ROSE BABICH,
Notary Public.

My Commission Expires April 1, 1949. [5]

S *Wilshire & Western Sandwiches, Inc.*

EXHIBIT "A"

Copy

Treasury Department
Internal Revenue Service
417 South Hill Street
Los Angeles 13, California

LA:IT:90D:PAK

January 31, 1946

Wilshire and Western Sandwiches, Inc.
3180 West Sixth Street
Los Angeles 5, California

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1941, 1942 and 1943 discloses a deficiency of \$1,382.59 for the taxable years ended December 31, 1942 and 1943, and an overassessment of \$602.47 for the taxable year ended December 31, 1941, and that the determination of your declared value excess-profits tax liability for the taxable year ended December 31, 1943, discloses a deficiency of \$168.31, and that the determination of your excess-profits tax liability for the taxable years ended December 31, 1942 and 1943, discloses a deficiency of \$1,797.05 for the taxable year ended December 31, 1943 and an overassessment of \$706.81 for the taxable year ended December 31, 1942, as shown in the statement attached.

Exhibit A—(Continued)

After careful consideration of your applications for relief under section 722 of the Internal Revenue Code filed on September 15, 1943 for the taxable years ended December 31, 1941 and December 31, 1942 it has been determined that you have not established your right to the relief therein requested. In accordance with the provisions of sections 272 and 732 of the Internal Revenue Code, notice is hereby given of the deficiencies mentioned and of the disallowance of the claims for refund asserted in your application for relief under section 722.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiencies mentioned.

Very truly yours,

JOSEPH D. NUNAN, JR.,
Commissioner,

By GEORGE D. MARTIN,
Internal Revenue Agent in
Charge.

Enclosures: Statement, Form of waiver, Form 843.

Exhibit A—(Continued)

STATEMENT

LA:IT:90D:PAK

Wilshire and Western Sandwiches, Inc.

3180 West Sixth Street

Los Angeles 5, California

Tax Liability for the Taxable Years Ended
December 31, 1941 to 1943, Inclusive

Income Tax

Year	Liability	Assessed	Overassessment	Deficiency
1941	\$ 469.81	\$ 1,072.28	\$602.47	
1942	2,591.47	1,991.60	.....	\$ 599.87
1943	2,898.61	2,115.89	.....	782.72
	<hr/>	<hr/>	<hr/>	<hr/>
Totals	\$ 5,959.89	\$ 5,179.77	\$602.47	\$1,382.59

Declared Value Excess-Profits Tax

1943	\$ 758.00	\$ 589.69	\$ 168.31
------	-----------	-----------	-------	-----------

Excess Profits Tax

1942	None	\$ 706.81	\$706.81	
1943	\$22,158.79	20,361.74	.....	\$1,797.05
	<hr/>	<hr/>	<hr/>	<hr/>
Totals	\$22,158.79	\$21,068.55	\$706.81	\$1,797.05

In making this determination of your tax liability, careful consideration has been given to the applications for relief filed on September 15, 1943, for the taxable years ended December 31, 1941 and 1942, to the report of examination dated November 9, 1944, to your protests dated March 26, 1945, and October 31, 1945, and to the statements made at conferences held.

Exhibit A—(Continued)

Careful consideration has been given to your applications for relief (forms 991) under Section 722(c) of the Internal Revenue Code wherein you claim refunds or credits as follows: [7]

Taxable		Bureau		Refund or
Year	Form No.	Serial No.	Filed	Credit Claimed
1941	991	25330	9-15-43	None
1942	991	25331	9-15-43	\$706.81

It is held that you have not established that the tax computed under Subchapter E of Chapter 2 of the Internal Revenue Code without the benefit of Section 722 of the Code, results in an excessive and discriminatory tax within the provisions of Section 722(a), (b) and (c) of the Code and that you have not established what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during the respective excess profits tax periods.

It is further held that you have not established any factors affecting your business which may be reasonably considered as resulting in an inadequate standard of normal earnings during the base period not inconsistent with principles underlying the provisions of subsection (c) of Section 722 of the Internal Revenue Code.

In your returns for the years 1942 and 1943 you claimed deductions in the respective amounts of \$1,500.00 and \$1,443.26 as interest paid on the indebtedness due to certain stockholders on amounts

Exhibit A—(Continued)

paid to the corporation by them. It is determined that such amounts of alleged interest are not deductible within the purview of Section 23(b) of the Internal Revenue Code.

The issue in your claim for refund (form 843) for the taxable year ended December 31, 1941, filed on February 24, 1945, for the allowance as deductions of items of expense aggregating \$2,859.70 is conceded and appropriate adjustments therefor is made herein.

The overassessment of income tax for the taxable year ended December 31, 1941, shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 322(a) of the Internal Revenue Code.

The overassessment of excess profits tax for the taxable year ended December 31, 1942, shown herein, will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 322(a) of the Internal Revenue Code, provided that you fully protect yourself against the running of the statute of limitations with respect to the apparent overassessment referred to in this letter, by filing with the collector of internal revenue for your district, a claim for refund on form [8] 843, a copy of which is enclosed, the basis of which may be as set forth herein.

Exhibit A—(Continued)

Adjustments to Net Income

Taxable Year Ended December 31, 1941

Net income as disclosed by return.....	\$5,096.88	
Additional deductions:		
(a) Overstatement of income.....	\$518.25	
(b) Prepaid expenses allowed.....	669.39	
(c) Depreciation	816.08	
(d) Franchise tax	74.73	
(e) Capital stock tax	781.25	2,859.70
		<hr/>
Net income adjusted		\$2,237.18

Explanation of Adjustments

(a) Included in gross income reported in your return is the amount of \$518.25 representing moneys credited to income but actually due to Mr. H. B. Carpenter. It has been determined that this amount does not constitute your income and the amount so reported is eliminated.

(b) Amounts charged to prepaid expenses, not previously claimed by you, applicable to this taxable year have been allowed as follows:

Additional rent	\$660.88
Office expense	60.00
Miscellaneous taxes	29.24
	<hr/>
Total	\$750.12
Less: Overstatement of insurance.....	80.73
	<hr/>
Adjustment as above	\$669.39

(c) Depreciation in the amount of \$816.09, not previously claimed by you, is allowed as represent-

Exhibit A—(Continued)

ing a reasonable allowance for depreciation for the taxable year under section 23(1) of the Internal Revenue Code.

(d) An additional deduction is allowed for franchise tax in the amount of \$74.73.

(e) A deduction is allowed for capital stock tax, not previously claimed by you, in the amount of \$781.25. [9]

Computation of Income Tax

Taxable Year Ended December 31, 1941

Net income adjusted	\$2,237.18
Surtax net income	2,237.18
Normal-tax net income	2,237.18
Income tax:	
Normal tax—15% of \$2,237.18	335.58
Surtax—6% of \$2,237.18	134.23
	<hr/>
Correct income tax liability.....	\$ 469.81
Income tax assessed:	
Original, account No. 420657	1,072.28
	<hr/>
Overassessment of income tax.....	\$ 602.47

Adjustments to Net Income

Taxable Year Ended December 31, 1942

Net income as disclosed by return.....	\$ 8,532.02
Unallowable deductions:	
(a) Franchise tax	\$ 92.65
(b) Interest disallowed	1,500.00
	<hr/>
Total	\$10,124.67
Additional deduction:	
(c) Capital stock tax	156.25
	<hr/>
Net income adjusted	\$ 9,968.42

Exhibit A—(Continued)

Explanation of Adjustments

(a) The deduction claimed for franchise tax is \$92.65 in excess of the amount allowable under section 23(c) of the Internal Revenue Code.

(b) This adjustment has been previously explained.

(c) An additional deduction is allowed for capital stock tax in the amount of \$156.25. [10]

Adjustments to Excess Profits Net Income
Taxable Year Ended December 31, 1942

Excess profits net income as disclosed by return.....	\$	9,282.02
Unallowable deductions:		
(a) Franchise tax	\$	92.65
(b) Interest disallowed	1,500.00	1,592.65
		<hr/>
Total		\$10,874.67
Additional deductions:		
(c) Capital stock tax	\$	156.25
(d) 50% of interest on borrowed capital	750.00	906.25
		<hr/>
Excess profits net income adjusted.....	\$	9,968.42

Explanation of Adjustments

(a) (b) and (c) These adjustments are the same as made to net income and previously explained.

(d) In computing the amount of excess profits net income shown in your return you decreased the deduction for interest by \$750.00 as representing 50 per centum of interest on borrowed capital as provided in section 711(a)(2)(B) of the Internal Revenue Code. It has been determined, under item (b) above, that the deduction claimed for interest on

Exhibit A—(Continued)

borrowed capital does not represent a proper deduction under section 23(b) of the Internal Revenue Code. Accordingly, the reduction of interest made by you is reversed.

Adjustments to Invested Capital

Taxable Year Ended December 31, 1942

Invested capital as disclosed by return.....	\$43,708.38
Additions:	
(a) Money paid in for stock or as contribution to capital	\$25,000.00
(b) 25% of new capital.....	13,750.00
(c) Accumulated earnings and profits increased	558.99 39,308.99
Total	\$83,017.37
Reduction:	
(d) Average borrowed invested capital disallowed....	12,500.00
Invested capital adjusted	\$70,517.37

Explanation of Adjustments

(a) and (d) It has been determined that the amount of \$25,000.00 shown in your return as borrowed capital, constitutes money paid in for stock or as a contribution to capital. Accordingly, the amount of \$25,000.00 is added to the equity invested capital shown in your return and the amount of average borrowed invested capital, \$12,500.00, claimed in your return is disallowed.

(b) There is added to your invested capital the amount of \$13,750.00 representing 25 per cent of new capital paid in during a taxable year beginning after December 31, 1940, in the amount of \$55,000.00, not previously claimed by you, in accordance with section 718(a)(6) of the Internal Revenue Code.

Exhibit A—(Continued)

(c) It has been determined that the amount of accumulated earnings and profits at the beginning of the taxable year was \$1,767.37 instead of the amount, \$1,208.38, shown by your return or an increase of \$558.99.

Computation of Excess Profits Tax

Taxable Year Ended December 31, 1942

Excess profits net income.....	\$ 9,968.42
Less: Specific exemption	\$5,000.00
Excess profits credit (8% of \$70,517.37 invested capital)	5,641.39 10,641.39
Adjusted excess profits net income.....	\$ 0.00
Correct excess profits tax liability.....	0.00
Excess profits tax assessed:	
Original, account No. 21079	706.81
Overassessment of excess profits tax.....	\$ 706.81

Computation of Income Tax

Taxable Year Ended December 31, 1942

Net income adjusted	\$ 9,968.42
Less: Income subject to excess profits tax.....	0.00
Surtax net income	\$ 9,968.42
Normal-tax net income	9,968.42
Income tax:	
Normal tax:	
15% of \$5,000.00.....	\$750.00
17% of \$4,968.42.....	844.63 1,594.63
Surtax:	
10% of \$9,968.42.....	996.84
Correct income tax liability	\$ 2,591.47
Income tax assessed:	
Original, account No. 20696	1,991.60
Deficiency of income tax.....	\$ 599.87

Exhibit A—(Continued)

Adjustments to Net Income

Taxable Year Ended December 31, 1943

Net income as disclosed by return.....	\$33,934.66
Unallowable deductions:	
(a) Accrued franchise tax disallowed....	\$1,206.82
(b) Interest disallowed	1,443.36
	<hr/>
Total	\$36,584.84
Additional deduction:	
(c) Capital stock tax	100.00
	<hr/>
Net income adjusted	\$36,484.84

Explanation of Adjustments

(a) In your return a deduction was claimed for accrued franchise tax in the amount of \$1,206.82. It has been determined that the liability for this tax did not accrue during the taxable year and the deduction claimed is, accordingly, disallowed. [13]

(b) This adjustment has been previously explained.

(c) An additional deduction is allowed for capital stock tax in the amount of \$100.00.

Computation of Declared Value Excess-Profits Tax

Taxable Year Ended December 31, 1943

Net income adjusted	\$36,484.84
Less: 10% of \$250,000.00 value of capital stock as declared in your capital stock tax return for the year ended June 30, 1943	25,000.00
	<hr/>
Net income subject to declared value excess-profits tax..	\$11,484.84
Declared value excess-profits tax: 6.6% of \$11,484.84....	758.00
Correct declared value excess-profits tax liability.....	758.00
Declared value excess-profits tax assessed:	
Original, account No. 411070	589.69
	<hr/>
Deficiency of declared value excess-profits tax.....	\$ 168.31

Exhibit A—(Continued)

Adjustments to Excess Profits Net Income
Taxable Year Ended December 31, 1943

Excess profits net income as disclosed by return.....	\$33,806.96	
Unallowable deductions:		
(a) Accrued franchise tax disallowed....	\$1,206.82	
(b) Interest disallowed	1,443.36	
(c) Decrease in deductions for declared value excess-profits tax	91.38	2,741.56
		<hr/>
Total		\$36,548.52
Additional deductions:		
(d) Capital stock tax	\$100.00	
(e) 50% of interest on borrowed capital....	721.68	821.68
		<hr/>
Excess profits net income adjusted.....		\$35,726.84

Explanation of Adjustments

(a) (b) and (d) These adjustments are the same as made to net income and previously explained.

(c) In computing the amount of excess profits net income shown in your return you claimed a deduction for declared value excess-profits tax in the amount of \$849.38. It has been determined that the correct deduction for declared value excess-profits tax for this taxable year was \$758.00, or a decrease of \$91.38.

(e) In computing the amount of excess profits net income shown in your return you decreased the deduction for interest by \$721.68 as representing 50 per centum of interest on borrowed capital as provided in section 711(a)(2)(B) of the Internal Revenue Code. It has been determined, under item (b) above, that the deduction claimed for interest does not represent a proper deduction under section 23(b) of the

Exhibit A—(Continued)

Internal Revenue Code. Accordingly, the reduction of interest, made in your return, is reversed.

Adjustments to Invested Capital

Taxable Year Ended December 31, 1943

Invested capital as disclosed by return.....	\$45,862.67	
Additions:		
(a) Money paid in for stock or as con- tribution to capital	\$25,000.00	
(b) 25% of new capital	13,750.00	
(c) Increase in accumulated earnings and profits	461.77	39,211.77
	<hr/>	<hr/>
Total		\$85,074.44
Reduction:		
(d) Average borrowed invested capital disallowed....	8,750.00	
	<hr/>	<hr/>
Invested capital adjusted		\$76,324.44

Explanation of Adjustments

(a) It has been determined that the amount of \$25,000.00 represents money paid in for stock instead constituting borrowed capital as claimed in your return. Accordingly, the amount of equity invested capital shown in your return is increased by \$25,000.00.

(b) There is added to the equity invested capital shown in your return the amount of \$13,750.00 representing 25 per cent of new capital, \$55,000.00, paid in during a taxable year beginning after December 31, 1940, not previously claimed by you, in accordance with section 718(a)(6) of the Internal Revenue Code.

Exhibit A—(Continued)

(c) It has been determined that the amount of accumulated earnings and profits at the beginning of the taxable year was \$7,574.44 instead of the amount, \$7,112.67, shown by your return, or an increase of \$461.77.

(d) In computing the amount of invested capital shown by your return you included the amount of \$8,750.00 as representing average borrowed invested capital resulting from money paid in by stockholders and claimed by you to represent borrowed capital. It has been determined, in item (a) above, that the money paid in by stockholders constitutes money paid in for stock or as a contribution to capital. Accordingly, the amount of average borrowed invested capital reported in your return on account of this transaction, \$8,750.00, is reversed.

Computation of Excess Profits Tax

Taxable Year Ended December 31, 1943

Excess profits net income	\$35,726.84	
Less: Specific exemption	\$5,000.00	
Excess profits credit (8% of \$76,324.44		
invested capital)	6,105.96	11,105.96
Adjusted excess profits net income.....		\$24,620.88
Excess profits tax: 90% of \$24,620.88.....		22,158.79
(Limitation under section 710(a) (1) (B)		
not applicable)		
Correct excess profits tax liability.....		22,158.79
Excess profits tax assessed:		
Original, account No. 400310.....		20,361.74
Deficiency of excess profits tax.....		\$ 1,797.05

Exhibit A—(Continued)

Computation of Income Tax

Taxable Year Ended December 31, 1943

Net income adjusted		\$36,484.84
Less: Declared value excess-profits tax.....	\$ 758.00	
Income subject to excess profits tax.....	24,620.88	25,378.88
		<hr/>
Surtax net income		\$11,105.96
Normal-tax net income		\$11,105.96
Income tax:		
Normal tax:		
15% of \$5,000.00.....	\$ 750.00	
17% of \$6,105.96.....	1,038.01	\$ 1,788.01
		<hr/>
Surtax:		
10% of \$11,105.96.....		1,110.60
		<hr/>
Correct income tax liability.....		\$ 2,898.61
Income tax assessed:		
Original, account No. 411070		2,115.89
		<hr/>
Deficiency of income tax.....		\$ 782.72

[Endorsed]: T.C.U.S. Filed April 24, 1946. [17]

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, and 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies the allegations of error contained in subparagraphs (a), (b), and (c) of paragraph 4 of the petition.

5. Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the [18] Commissioner be approved.

/s/ J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of counsel:

B. H. NEBLETT,
Division Counsel.

E. C. CROUTER,
R. E. MAIDEN, JR.,
Special Attorneys,
Bureau of Internal Revenue.

REM/emb 5/23/46

[Endorsed]: T.C.U.S. Filed May 29, 1946. [19]

[Title of Tax Court and Cause.]

MOTION TO AMEND PETITION TO
CONFORM TO PROOF

Comes now the Petitioner, by its attorney, Martin H. Webster, and moves this honorable Court to grant the said Petitioner leave to file an amendment to the petition already on file in this cause, under which amendment paragraph 5 (a) of the original petition shall be stricken therefrom and the following paragraph 5 (a) substituted therefor:

“5. The facts upon which the Petitioner relies as the basis of this proceeding are as follows:

(a) Uncertainty existed at the time of incorporation of Petitioner as to exactly how much money would be needed by Petitioner to erect a building for its business and to purchase the equipment required therefor, although it was thought that Thirty Thousand Dollars (\$30,000) would probably be sufficient. Accordingly, the [20] original capitalization of Petitioner was planned to consist of the issuance of One Thousand Five Hundred (1500) shares of capital stock at the par value of Ten Dollars (\$10.00) each, or a total of Fifteen Thousand Dollars (\$15,000) as a capital contribution, and approximately Fifteen Thousand Dollars (\$15,000) from the stockholders of Petitioner as loans. A total of Fifty-Five Thousand Dollars (\$55,000) was, in fact, required for the construction of the building and the equipment thereof. Thirty Thousand Dollars (\$30,000) of this

requirement was satisfied by the issuance by the corporation of Three Thousand (3000) shares of its common stock at the par value of Ten Dollars (\$10.00) per share; and the balance of the issuance by Petitioner of Twenty-Five Thousand Dollars (\$25,000) of its promissory notes, repayable in two years, bearing interest at the rate of six percent per annum. Interest was in fact accrued and paid on these notes, the books of Petitioner recorded the interest as an expense, and the advances to it by its stockholders as loans. The Commissioner has erroneously considered these loans as in fact capital contributions.” [21]

The reason for this motion is that the proof in the trial of this matter differs from the allegations contained in paragraph 5 (a) of the original petition, and this motion is made in order to conform said pleading to the proof.

Respectfully submitted,

/s/ MARTIN H. WEBSTER,
Counsel for Petitioner.

Dated: December 8, 1947.

[Endorsed]: T.C.U.S. Filed Dec. 12, 1947. [22]

[Title of Tax Court and Cause.]

ANSWER TO THE AMENDMENT TO
PETITION

The Commissioner of Internal Revenue, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, for answer to the amendment to paragraph 5(a) of the original petition of the above-named taxpayer, says:

5(a). Denies the allegations contained in paragraph 5(a) of the amendment to the original petition.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ CHARLES OLIPHANT,
Chief Counsel,
Bureau of Internal Revenue.

Of counsel:

B. H. NEBLETT,
Division Counsel.

E. C. CROUTER,
R. E. MAIDEN, JR.,
Special Attorneys,
Bureau of Internal Revenue.

REM/vp 12/23/47

[Endorsed]: T.C.U.S. Filed Dec. 26, 1947. [23]

The Tax Court of the United States

Wilshire and Western Sandwiches, Inc., Petitioner,
v. Commissioner of Internal Revenue, Re-
spondent.

DOCKET No. 10638

Martin H. Webster, Esq., and Jacob Shearer,
Esq., for the petitioner.

R. E. Maiden, Jr., Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT
AND OPINION

Disney, Judge: This proceeding involves deficiencies of \$599.87 and \$782.72 in income tax for the years 1942 and 1943, respectively, and a deficiency of \$168.31 in declared value excess profits tax and \$1,797.05 in excess profits tax for 1943. The issue is whether the respondent erred in disallowing as deductions for interest \$1,500 in 1942 and \$1,443.36 in 1943. The stipulation of facts filed by the parties is incorporated herein by reference as part of our findings of fact. [24]

FINDINGS OF FACT

The petitioner was incorporated on March 24, 1941, under the laws of California, with an authorized capital stock of 7,500 shares of common stock, par value \$10 each, for the purpose of engaging in the drive-in restaurant business. The incorporators of petitioner were M. A. McDonnell, William H. Simon, Mike Lyman, and Harry B. Carpenter. Its articles of incorporation empowered petitioner, among other things, to borrow

money and issue its notes therefor. It kept its books and prepared its returns on the accrual basis. It filed its returns for the taxable years with the collector for the sixth district of California.

Discussions resulting in the formation of petitioner started the early part of 1941. The original plan was to operate a combination drive-in and restaurant and cocktail room at Wilshire and Western Avenues, as a substitute for an old drive-in restaurant then being operated by Carpenter a block away. A lease was negotiated under the terms of which the lessor was to erect suitable improvements at a cost of about \$75,000. Carpenter did not desire to operate a combination restaurant on account of its size. In the meantime, Simon, acting for himself, negotiated a lease for another corner of Wilshire and Western Avenues for the purpose of operating a drive-in restaurant. Thereafter, but before petitioner was incorporated, the interested parties abandoned the plan under consideration and decided to construct a drive-in restaurant on the lot covered by the lease negotiated by Simon.

About April 1941 petitioner's incorporators discussed for the first time the question of financing the construction of the restaurant out of advances by them to petitioner for the purchase of its stock and as loans. The original [25] intention was to make advances totaling \$30,000 for stock and loans on an equal basis. The individuals desired to be in a position to participate with general creditors for part of their investment in the event petitioner's

business was not successful. In addition, they regarded a loan to be a better investment than stock to obtain returns on and repayment of their capital outlay. The individuals discussed the question of borrowing money from a bank and decided that they would rather receive the interest than to have petitioner pay it to a bank. They also discussed the tax benefit that would accrue to them and petitioner under the plan. Simon, who with his brother Mike Lyman was regarded as a unit in the transaction, considered his contemplated loan to be a safe investment. The same individuals, or some of them, entered into similar transactions for the same reasons with nine other corporations, one each in 1937 and 1939, six in 1941, and one in 1942. In all except two of the transactions, the notes received for loans were in proportion to the stock received.

Simon negotiated for, and on April 26, 1941, entered into, a lease for a corner lot at Wilshire Boulevard and Western Avenue, Los Angeles, for a period of 15 years. The lease provided for the improvement of the premises by a drive-in restaurant building at a cost of not less than \$30,000. The lease was acquired by Simon with the understanding that he would assign it to petitioner, and was assigned by him to petitioner in July 1941. The understanding was that Carpenter would supervise the construction of the building and operate the business. Three of the four individuals estimated that the improvements, including equipment, would cost about \$30,000. Carpenter, the other individual,

first believed that the cost would be about \$50,000, and in [26] July 1941, concluded that the cost would be \$38,000 or \$39,000. Simon and Carpenter estimated that the cost of the equipment would about equal the cost of the building.

About June 15, 1941, bids were solicited for the construction of the building on the leased premises, and on July 10, 1941, a contract was entered into for the construction of a building at a cost of \$22,651. The construction work was substantially completed about October 25, 1941, and the restaurant was opened for business about November 5, 1941.

The incorporators of petitioner made the following payments, totaling \$55,000, to petitioner in 1941 under the plan previously adopted by them.

	McDonnell	Simon	Lyman	Carpenter
May	\$3,333.33	\$	\$	\$
June	.....	1,666.67	1,666.66	3,333.34
August	.....	2,500.00	2,500.00	.....
September	5,000.00	.....	.....	5,000.00
October	.....	2,500.00	2,500.00	.....
Nov. 13	.....	2,500.00	2,500.00	.....
Nov. 19	10,000.00	.....	.....	5,000.00

The payments made on November 13th and 19th were agreed upon at an informal meeting held on November 12. At the same meeting the parties reached an agreement on the division of the advances between stock and notes. At the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof, and notes for the remainder. No receipts were given by petitioner for the advances.

The money was first used to pay for the cost of

preparing plans and specifications for the building, and thereafter for the construction of the building and the equipment installed therein. The amount of \$38,114.68 was spent in 1941 for the building and \$17,515.78 for equipment, a total of \$55,630.46. In January 1942, the additional amount of \$2,375 was spent for building costs and, in that and the next month the additional amount of \$7,787.26 was spent for equipment. An expenditure of \$55,000 was necessary to place the restaurant in condition to open for business.

About February 1, 1942, petitioner borrowed \$10,000 from its stockholders to pay bills outstanding for the construction of the building and equipment of the restaurant. Carpenter and McDonnell each loaned one-third of the amount and Simon and Lyman each a one-sixth. Carpenter did not advise the other stockholders of the need for the money until a short time before the loans were made. The loans were paid on September 7, 1942, without interest.

About July 14, 1941, petitioner, pursuant to a resolution adopted by its Board of Directors on that day, filed an application with the Department of Investment of the State of California for permission to issue 1,500 shares of its stock for cash to its incorporators, and G. C. Jobson, and the remainder of its stock when authorized by its Board of Directors. The application recited that petitioner proposed to borrow from the stockholders or incorporators an additional amount sufficient to complete the building and equip it for the opera-

tion of a restaurant. At the same meeting, Carpenter was elected president and Simon vice president of petitioner. On July 17, 1941, the Commissioner of Corporations authorized petitioner to sell to the individuals named in its application for cash, at par, not to exceed 7,500 shares of its stock.

At a meeting of the Board of Directors of petitioner, the membership of which included the four incorporators, on November 13, 1941, a resolution was adopted, in accordance with an agreement reached at an informal meeting the [28] previous day, to issue to the incorporators for advances made by them promissory notes, totaling \$25,000, maturing in two years with interest at the rate of 6 per cent per annum, payable quarterly, and stock, totaling \$30,000, as follows:

	Carpenter	McDonnell	Simon	Lyman
Stock	\$10,000.00	\$10,000.00	\$5,000.00	\$5,000.00
Notes	8,333.34	8,333.33	4,166.67	4,166.66

The stock and notes authorized by the resolution were issued under date of November 13, 1941, and were delivered by December 5, 1941. In case of default in the payment of interest, the notes were to be immediately due and payable at the option of the holder. On November 25, 1941, 50 shares each of the stock issued to Simon and Lyman were transferred to Joseph Lardemar, in accordance with a gift made of the stock prior to November 13, 1941.

Carpenter expected the notes to be paid if petitioner had funds for that purpose. Simon expected the notes to be paid out of current earnings

and would not have insisted upon payment if payment would have caused financial hardship to petitioner.

Amounts, totaling \$3,055.86, were paid to the noteholders on December 1943, as interest on the notes to November 30, 1943. Like payments, aggregating \$682.10, were paid on March 23, 1945. The amounts were entered on the books of petitioner as a charge to an account under the name of "Interest Payable Accrued," which account was opened in February or March 1943, as of the close of 1942, with a credit to the account as interest accrued on the notes to December 31, 1942. The face amount of the notes was paid in full by payments of \$10,000 each, on April 21, 1943, and May 23, 1944, and \$5,000 [29] on March 23, 1945. The payment to the holder of each note was in proportion to his holdings of all of the notes.

In October 1941, Carpenter requested a certified public accountant to outline a set of books for petitioner's bookkeeper to install and use. After receiving the minutes of petitioner, the accountant prepared a list of entries. The journal entry showed that petitioner was incorporated with a capital of \$75,000, consisting of 7,500 shares of a par value of \$10 each. The outline of accounts to be used included an account for notes payable. Carpenter did not inform the accountant that part of the advances made by the incorporators was to be treated as loans to the corporation.

Petitioner's account under the name of "Capital Stock Unissued" contained a charge of \$75,000 and

a credit of \$55,000 on December 31, 1941. Its account "Stock Subscriptions Receivable" contained at that time a charge of \$55,000 and a credit for the same amount. The books also showed capital stock of \$75,000, of which \$55,000 was set aside against an account under the name of "Cash Special \$55,000." The books did not, on December 31, 1941, reflect any notes payable to stockholders. Sometime between January 15 and March 7, in 1942, the accountant took a trial balance from petitioner's books for the purpose of preparing petitioner's income tax returns for 1941. The balance sheet included in the income and declared value excess profits tax return listed as an asset capital stock subscriptions in the amount of \$55,000 and as a liability a like amount for capital stock. The return was signed by Carpenter, as president, and H. B. Carpenter, Jr., as treasurer, without objection to the return as prepared by the accountant or reading the return. Petitioner's president was aware that the affidavit he signed contained a statement that the return was correct. [30]

In April or May 1942, petitioner employed another accountant to examine its books. The accountant had knowledge that the stockholders of petitioner held notes of the corporation. He ascertained from a trial balance taken as of December 31, 1941, that the books did not reflect the notes issued to the stockholders under the date of November 13, 1941, and erroneously reflected the capital stock outstanding. After discussing the matter with Carpenter and Simon, the accountant made entries in

the books to reflect notes outstanding of \$25,000 and capital stock outstanding of \$30,000. While the accountant was preparing petitioner's income tax return for 1942, he ascertained that no amount had been accrued for interest on the notes. An appropriate account was then opened and the amount of \$1,687.50 was entered therein as interest accrued on the notes to the close of 1942. Thereafter interest was accrued on the notes monthly.

The earned surplus account of petitioner discloses credit balances of \$2,468.16, \$9,740.40, \$17,980.01, \$45,752.61, \$51,349.06, and 59,289.40 at the close of the years 1941 to 1946, inclusive. The account contains no charge for dividends.

Petitioner's president, who testified at the hearing, was at an undisclosed time indicted in a Federal district court in California for filing false and fraudulent individual returns and like returns for a firm doing business under the name of Carpenter's Drive-In. At the trial, Carpenter entered a plea of nolo contendere and paid a fine, imposed by the court. No sentence of imprisonment was imposed by the court.

In its returns for 1942 and 1943 the petitioner claimed \$1,500 and \$1,443.26, respectively, as deductions for interest on the notes held by its [31] stockholders. In his determination of the deficiencies the respondent held that the amounts were not deductible under section 23(b) of the Internal Revenue Code.

OPINION

The disagreement between the parties is whether the notes issued to the stockholders of petitioner constitute indebtedness within the meaning of section 23(b) of the Internal Revenue Code, as contended by petitioner, or investments in and contributions to capital of petitioner, as contended by the respondent. Petitioner contends that Cleveland Adolph Mayer Realty Corporation, 6 T.C. 730, is determinative of the issue here. The respondent cites *Edward G. Janeway*, 2 T.C. 197, *aff'd*, 147 Fed(2d) 602, as having facts similar to those prevailing here.

Promissory notes were issued for the amounts; the instruments and accrued interest thereon were belatedly entered in the corporate books as such; interest on and principal of the notes were eventually paid; and there is testimony in the record that the parties intended the amounts as loans. The question is factual and such evidence must be weighed with other facts of record to determine the true character of the amounts. *Joseph B. Thomas*, 2 T.C. 193; *Edward G. Janeway*, *supra*; *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179.

The general plan was decided upon prior to any business activity of petitioner and was intended to meet capital outlays which are usually paid out of invested capital and/or secured indebtedness. Similar arrangements were made by the stockholders, or some of them, in connection with other corporations formed to engage in the restaurant business. No evidence was offered to [32] establish that the

individuals were lenders of money other than under plans such as the one here under consideration.

The advances here have few of the usual characteristics of commercial loans entered into in arm's length transactions. All of the amounts were paid in to provide petitioner with funds to start business, hence all of it was working capital. The original plan was to take stock and notes on an equal basis and three of the four interested parties estimated that an expenditure of about \$30,000 would be sufficient to open the restaurant for business. The amount of \$55,000 was required to place the restaurant in condition to commence business, yet there was no agreement to advance the final \$30,000 paid in until November 12, 1941, which was a week after the restaurant was opened for business, and until then no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans. The plan finally adopted and made effective on the division of the advances between stock and notes was not in accordance with the agreement originally entered into, which discloses that the parties were at all times in a position to divide the advances between stock and notes in any proportion. The portion regarded as a loan by each stockholder was in direct proportion to his holding of stock.

Carpenter committed petitioner to pay additional construction costs, in the amount of about \$10,000, without the consent of the other incorporators. Such amount was borrowed, without interest, from

the stockholders in direct proportion to stockholdings. The loans altered the ratio of stock to loans from 30-25 to 30-35, and is evidence that the individuals were not dealing with petitioner as "mere lenders." Some of the funds were advanced as early as [33] May 1941, yet no interest thereon was incurred by petitioner prior to November 13, 1941. In the meantime, there was no agreement on when interest would start, the rate of interest, or an agreement with petitioner on when the loans would mature, contrary to the manner loans are generally made.

The treatment of the notes on the books and payment of the obligations is significant. The notes were not entered in the books until April or May 1942, and although interest was payable quarterly, none was accrued on the books until 1943 and no interest was paid until December 1, 1943, or more than two years after the notes were executed. The terms of the instruments gave to the holders thereof the right to declare the principal and interest immediately due and payable upon default in the payment of interest when due. No evidence was offered that any of the note holders exercised the right. The final payment on the notes was not made until March 23, 1945, or more than sixteen months after maturity, and the payment made each time to each was in direct proportion to his holdings of all of the notes. No evidence was offered to show any demand for payment at maturity. The \$10,000 borrowed about February 1, 1942, without interest, was paid in full by one payment made on Septem-

ber 7, 1942, which was about fifteen months before the first interest payment was made on the notes. No additional capital was invested in the business, with the result that the notes were paid, as the parties intended, out of operating income.

The intent of the parties with respect to a part of the advances as bona fide loans, is reflected in testimony of Simon, who, with his brother, regarded as a unit in the transaction, and Carpenter. The former testified that he expected the note to be paid at maturity, but would not have insisted [34] upon payment if payment would result in financial hardship to petitioner. The latter did not expect payment unless petitioner had funds. It is apparent from the testimony that they did not intend to assert rights of a bona fide lender; instead regarded the amounts as being subject to the risks of the business and looked to repayment out of corporate earnings. There was no need to acquire an additional proprietary interest for the amounts, in view of the fact that the stock issued for remainder of the advances gave each stockholder the same control he would have had had the stock alone been issued.

The petitioner had earned surplus of about \$51,000 by the close of 1945, or double the amount of its outstanding stock, yet paid no dividends on its stock during that period, which strongly indicates that the stockholders looked to the notes for income on their investments and a partial return of capital.

Testimony is present that hazards of the restaurant business was one of the reasons for the

plan adopted and carried out. Other testimony requires us to refuse to accept it at its face value. Advances totaling \$65,000 were eventually made in a venture which three of the interested parties thought could be started in business by a capital outlay of only about \$30,000, and the third, Carpenter, about \$38,000. Simon thought the loan was safe and all of them preferred the plan over a bank loan for the amount covered by the notes. Such opinions and action is opposed to the idea that the parties had any great concern about the financial success of the business.

Further discussion of the facts seems unnecessary. The substance of the plan, which must prevail over the form thereof, was to make capital contributions, subject to an understanding of the participants, that they would be repaid in full if the petitioner had sufficient earnings to make the payments without financial hardship to it. Accordingly,

Decision will be entered for the respondent.

Entered June 29, 1948. [36]

(Seal)

The Tax Court of the United States

Docket No. 10638

WILSHIRE AND WESTERN SANDWICHES,
INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, entered June 29, 1948, it is

Ordered and Decided: That there are deficiencies in income tax of \$599.87 and \$782.72 for the years 1942 and 1943, respectively, and a deficiency of \$168.31 in declared value excess-profits tax and \$1,797.05 in excess profits tax for the year 1943.

(Seal) /s/ R. L. DISNEY,
Judge.

Entered June 29, 1948. [37]

In the United States Court of Appeals
for the Ninth Circuit

Tax Court Docket No. 10638

WILSHIRE & WESTERN SANDWICHES,
INC., a corporation,

Petitioner on Review,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

PETITION FOR REVIEW OF DECISION OF
THE TAX COURT OF THE UNITED STATES

To the Honorable Judges of the United States
Circuit Court of Appeals for the Ninth Circuit:

Comes now Wilshire & Western Sandwiches,
Inc., a corporation, by Swarts, Tannenbaum, Zif-
fren & Steinberg and Jacob Shearer, its attorneys,
and respectfully shows:

I.

The Petitioner herein referred to as the "tax-
payer," is a resident of Los Angeles County in the
State of California, and its address is 3180 West
Sixth Street, Los Angeles 5, California.

The Respondent is the duly appointed, qualified,
and acting Commissioner of Internal Revenue of
the United [38] States; George J. Schoeneman,
herein referred to as the "Commissioner."

The taxpayer filed income tax returns, excess
profits tax returns and declared value excess prof-
its tax returns for the taxable years 1942 and 1943

with the Collector of Internal Revenue for the Sixth District of California, whose office is located within the Ninth Judicial Circuit, wherein the taxpayer also resides.

II.

The Commissioner determined deficiencies of five hundred ninety eight dollars and eighty seven cents (\$598.87) and seven hundred eighty two dollars and seventy two cents (\$782.72) in the taxpayer's income tax for the years 1942 and 1943 respectively and determined deficiencies of one thousand seven hundred ninety seven dollars and five cents (\$1,797.05) and one hundred sixty eight dollars and thirty one cents (\$168.31) in the taxpayer's excess profits taxes and declared value excess profits taxes respectively for the year 1943 and on January 31, 1946, in accordance with the provisions of the applicable statute, sent to the taxpayer, by registered mail, a notice of the aforementioned deficiency.

Within ninety (90) days thereafter, the taxpayer filed a petition for review by the Tax Court. The case was tried and submitted and on June 29, 1948, the Tax Court promulgated a decision wherein it ordered and decided that [39] there were deficiencies in the amount of five hundred ninety eight dollars and eighty seven cents (\$598.87) and seven hundred eighty two dollars and seventy two cents (\$782.72) in the taxpayer's income taxes for the years 1942 and 1943, respectively, and deficiencies in the amounts of one thousand seven hundred ninety seven dollars and five cents (\$1,797.05)

and one hundred sixty eight dollars and thirty one cents (\$168.31) in the taxpayer's excess profits taxes and declared value excess profits taxes respectively for the taxable year 1943.

III.

The aforesaid deficiencies resulted from a determination by the Commissioner that the sum of fifteen hundred dollars (\$1,500.00) accrued in the year 1942 and of one thousand four hundred forty three dollars and twenty six cents (\$1,443.26) accrued in the year 1943, and paid by the taxpayer as interest on loans to it by its shareholders, was not deductible from gross income as interest on an indebtedness in determining its net income subject to tax. The capitalization of the taxpayer consisted of the issuance of three thousand (3,000) shares of capital stock at the par value of ten dollars (\$10.00) each, or a total of thirty thousand dollars (\$30,000.00) as capital contribution. In addition the incorporators of the taxpayer agreed to lend the taxpayer such amounts of money as might in the future be [40] found to be necessary for these purposes. Pursuant to this agreement, some of the stockholders of the taxpayer loaned sums of money to the taxpayer in the aggregate amount of twenty five thousand dollars (\$25,000.00). All such loans were evidenced by promissory notes, were payable in two (2) years and bore interest at the rate of six per cent (6%) per annum. Interest was in fact accrued and paid on these notes and the books of the corporation recorded the interest as an expense and the advances to it by its

stockholders as loans. The Commissioner contended that the amounts so loaned to the taxpayer were capital contributions and that consequently the amounts paid as interest were not paid as interest on an indebtedness and so not deductible by the taxpayer from its gross income in computing its net income subject to tax. The Commissioner's contention was upheld by the Tax Court and taxpayer says that in this the Tax Court committed error.

IV.

The taxpayer says in the record and proceedings before the Tax Court and in the decision and final order of redetermination rendered and entered by the Tax Court, manifest error occurred and intervened to the prejudice of the Petitioner and assigns and avers that the following errors and each of them occurred in said record, proceedings, decision and final order of redetermination and that upon [41] these it relies to reverse said decision and final order of determination so rendered and entered by the Tax Court, to wit:

1. The Tax Court erred in holding that the sum of fifteen hundred dollars (\$1,500.00) accrued in the year 1942 and of one thousand four hundred forty three dollars and twenty six cents (\$1,443.26) accrued in the year 1943 and paid by the taxpayer as interest on loans by its shareholders, was not deductible as interest on an indebtedness.

2. The Tax Court erred in refusing to hold that said sums mentioned above were interest on an indebtedness and as such were deductible from the

taxpayer's gross income in determining its net income subject to taxation.

3. The Tax Court erred in determining that there was a deficiency in the taxpayer's income taxes for the taxable years 1942 and 1943.

4. The Tax Court erred in determining that there was a deficiency in the taxpayer's excess profits tax for the taxable year 1943.

5. The Tax Court erred in determining that there was a deficiency in the taxpayer's declared value excess profits taxes for the year 1943.

Wherefore, the taxpayer petitions that the decision of the Tax Court of the United States be reviewed by the [42] United States Circuit Court of Appeals for the Ninth Circuit, that a transcript be prepared in accordance with the law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken by said Court to the end that the errors complained of may be reviewed and corrected.

SWARTS, TANNENBAUM, ZIFFREN
& STEINBERG and
JACOB SHEARER.

By /s/ JACOB SHEARER,
Attorney for Taxpayer.

[Endorsed]: T.C.U.S. Filed Sept. 20, 1948. [43]

[Title of U. S. Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR
REVIEW

To: Charles Oliphant, Chief Counsel of the Bureau
of Internal Revenue, Washington, D. C.

You will please take notice that on the 20th day
of September 1948, the Petitioner above named
filed with the Clerk of the Tax Court of the United
States at Washington, D. C., a petition for review
by the United States Circuit Court of Appeals for
the Ninth Circuit of the decision of the Tax Court
of the United States heretofore rendered in the
above entitled cause.

A copy of the petition for review as filed is here-
by attached and served upon you. [44]

Dated: this 20th day of September 1948.

SWARTS, TANNENBAUM, ZIFFREN
& STEINBERG and
JACOB SHEARER.

By /s/JACOB SHEARER,
Attorneys for Petitioner.

ACKNOWLEDGMENT OF SERVICE

Personal service of the foregoing notice together
with a copy of the petition for review is hereby
attached this 27th day of September 1948.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of Internal Revenue, Coun-
sel for Respondent.

[Endorsed]: T.C.U.S. Filed Sept. 27, 1948. [45]

In The Tax Court of the United States

Docket No. 10638

WILSHIRE AND WESTERN SANDWICHES,
INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Court Room No. 229,
United States Post Office and
Court House Building,
Los Angeles, California.
December 3, 1947—2:30 p.m.

(Met pursuant to notice.)

Before: Honorable Richard L. Disney, Judge.

Appearances: Martin H. Webster—215 West Seventh Street, Los Angeles, California, and Jacob Shearer—650 South Spring Street, Los Angeles, California, appearing for the Petitioner. R. E. Maiden, Jr. (Honorable Charles Oliphant, Chief Counsel, Bureau of Internal Revenue)—appearing for the Respondent. [47]

PROCEEDINGS

The Clerk: Docket 10638, Wilshire and Western Sandwiches. Inc. For the Petitioner Mr. Paul Ziffren and Mr. Jacob Shearer.

Mr. Shearer: Mr. Jacob Shearer and Mr. Martin H. Webster. I think he is of record, too, counsel.

The Clerk: Yes.

Mr. Shearer: He was one of the original counsel.

The Court: Is he present?

Mr. Webster: I am.

The Clerk: Mr. R. E. Maiden, Jr. for the Respondent.

Mr. Webster: If your Honor please—

The Court: Just a moment. It seems to be a question as to whether certain deductions for interest were allowable because of the contention as to whether there were loans or capital contributions. That seems to be your situation. State the matter for the Petitioner.

OPENING STATEMENT ON BEHALF OF THE PETITIONER

By Mr. Webster:

Mr. Webster: Your Honor, the tax years involved are the calendar years 1941, 1942 and 1943. As your Honor has already stated, the issues arise—one, as to the question of deductibility of interest, and two, as to the computation of the excess profits tax credit.

The Court: Why do you mention 1941? It isn't [49] mentioned in the petition. The petition says 1942 and 1943.

Mr. Maiden: There is an over-assessment for 1941 not involved in this proceeding, if the Court please.

The Court: The Petitioner says nothing, so far as I can see, about over-assessments. I have no jurisdiction over assessments, anyway.

Mr. Webster: That is right, your Honor.

The Court: Proceed.

Mr. Webster: The question as to the excess profit tax computation arises by reason of the difference in computation. If the moneys in question are considered equity investment capital, which they would be were they found by this Court to represent investments for the purchase of stock or borrowed capital, which they would be, if the Court finds for the Petitioner that these moneys in question were loans.

Stating the issue very simply, it seems to the Petitioner that this case turns on a question of intent, as to the intent of four individuals at the time in 1941 when they formed a corporation for the purpose of operating a drive-in restaurant operation on Wilshire Boulevard and Western Avenue.

For this purpose they formed a corporation. They made an estimate as to the amount of money which would be required to construct the drive-in and equipment, and at that time, at the time that they made this first estimate and before [50] construction began they agreed among themselves that probably 50 per cent of the moneys so required would be contributed to the corporation and be considered by the corporation as for the purchase of stock.

That approximately 50 per cent, that is, the balance, was intended by these individuals to constitute a loan.

The actual construction of the drive-in com-

menced in July of 1941; shortly prior thereto a meeting had been held of the board of directors of this corporation. This was on July 14th of 1941. At that time the intent and agreement which I have just summarized was incorporated in those minutes, the minutes of that meeting.

Additionally, still just prior to the actual construction, the board of directors authorized an application to be filed with the Corporation Commissioner for permission to issue stock, and in this application again stated its general plan of having a part loan-part stock setup. A permit was granted on that basis.

Shortly after construction commenced, construction of the drive-in, it was found that the actual costs would be in excess of the estimates. Accordingly, rather than issue stock immediately upon the granting of the permit by the California Corporation Commissioner, the board of directors decided to withhold such issuance of stock until such time as they had a better idea of how much the total cost would be. [51] This actual figure was arrived at or believed to have been arrived at in November, in the middle of November of 1941.

It was at that time that the board of directors again convened and agreed upon the final issuance of stock to the extent of \$30,000.00. They also agreed that the balance of the amount which they had thus far contributed toward the cost of the drive-in would constitute a loan.

Within two or three weeks after the meeting notes were issued in the amount of the loan, total-

ing \$25,000.00, and stock certificates were duly issued in the amount of \$30,000.00.

Thereafter, all activities of the corporation and of the individuals were consistent with this part loan-part stock setup, except for the manner in which the books and tax returns were handled. And with respect to that, your Honor, we propose to place upon the stand the accountant who came in within six months after the books were first set up. He will testify to the errors which he saw and also testify further to the correcting of those errors which he completed within approximately six months after the errors had first been made and before any revenue agent came in to raise any issue here.

We propose further, your Honor, to present testimony bringing out, not only the presence of an intent on the part of these individuals to lend, but also a good business purpose, [52] making reasonable such an intent.

Your Honor, it was hoped at this time that a Mr. Odell, who was an attorney, the attorney who handled all of the corporate transactions, from its inception, and is still handling that corporation today—it was hoped he would be here to be able to testify as to certain dates, which but recently placed in issue, dates of actual delivery of stock certificates and actual delivery of notes. Mr. Odell, unfortunately, is ill. If your Honor please, I should like to make a motion at this time, even though it is a little out of sequence in an opening statement, that in the event it is considered necessary at the

conclusion of this case, conclusion of the presentation of this case, I should like to move that this Court grant permission to bring Mr. Odell in at a later date, probably next week. I anticipate he will be well enough to come in to testify to certain facts, in the event that it is considered that those facts have not been adequately brought out through the testimony that we propose to present now.

The Court: I won't pass upon that motion at this time. We will discuss that at the end of the trial.

Mr. Webster: Very good, your Honor. Certain of the facts, your Honor, have been stipulated to.

The Court: Let's hear the Respondent's statement. Have you finished the statement of issues? Let's hear the [53] Respondent's statement, and then go into the question of your stipulation.

OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. Maiden:

Mr. Maiden: If it please the Court, of course, I am not apprised beyond the stipulated facts of what counsel expects to prove in this case, in support of their contention that certain of the advances made by these stockholders were, in fact, and in bona fides, loans to the corporation.

The stipulation of fact, which we have prepared, sets forth the formation of the corporation and one of the minutes and the permit filed with the Corporation Commissioner for the right to issue immediately 1500 shares of the stock, and the sub-

sequent right to issue an additional 5000 shares for cash; these shares having the value of \$10.00.

The articles of incorporation authorized the issuance of 7500 shares of a par value of \$10.00 per share.

It is the Respondent's position in this case that the advances—that no part of the advances made by these stockholders to the corporation were, in fact and in bona fides loans but that the entire amount of the advances made by these stockholders were investments in the business. And upon that determination the Respondent has disallowed deductions taken by the corporation in 1942 and 1943 for alleged interest payable on the purported loan obligations. [54]

I believe that is a sufficient statement from the Respondent as to our position in the case. We feel that the facts will support our contention that there were, in fact, no bona fide loans.

The Court: Put on your evidence for the Petitioner.

Mr. Webster: Your Honor, as has been mentioned, a stipulation has been entered into between Respondent and Petitioner incorporating, physically incorporating Exhibits 1-A through 7-G. In addition, counsel for Respondent is in possession of the original tax returns for the calendar years 1941, 1942 and 1943, which are not physically attached to the stipulation but which can be submitted at the same time. They are referred to in the stipulation and numbered respectively 8-H to 10-J.

Mr. Maiden: If the Court please, before the filing of this stipulation I note what appears to be a typographical error, which I would like to call to counsel's attention so we may correct it in ink before we hand in the stipulation.

Mr. Webster: Mr. Maiden, I have just checked that point and it seems proper.

Mr. Maiden: Your Honor, there seems to be an irreconcilable error in the stipulation. The part of it that is obviously in error, from my standpoint, is a copy of a permit filed with the Corporation Commissioner—

The Court: Why don't you strike that from your [55] stipulation and then later when you find out what is the fact file a separate short stipulation setting forth what the facts are?

Mr. Maiden: I could be wrong about it being an error, but I don't see how I can. I am willing to let the stipulation go in with the understanding that if this is an error I might call it to the Court's attention in my brief. I have not examined the original of this document. I have relied upon counsel's statement that it is a correct copy of the original.

The Court: Well, what if then you still don't agree on the matter?

Mr. Webster: I have examined the original document and believe this is an accurate copy. I am willing to stipulate to that effect, that we admit this stipulation, file the stipulation and in the event that the point now being raised by Mr. Maiden is accurate and that an error has been made, I will

stipulate that the change can be interlined in pencil in the exhibit.

Mr. Maiden: Your Honor, if the parties—if there is an error made and the parties are able to agree upon it, why, then we will call it to the Court's attention in the brief. Otherwise, the Respondent will pass it up. I don't think it is of any very obvious importance.

The Court: Then in your briefs state whether you [56] are in agreement on it.

Mr. Maiden: Yes, sir.

The Court: Make a point of that.

Mr. Maiden: Yes, sir.

The Court: If I hear nothing further about it, I will know you have concluded that you are in error and that the stipulation is correct.

Mr. Maiden: Yes. And in order to point up the particular place, I might state that the point in question occurs at page 7 of Exhibit 4-D to the stipulation, which will now be offered. It relates to whether or not the figure 5,000 at the top of that page should be 6,000 or the 5,000.

Now, at this time I offer the original and one copy of the stipulation of facts which the parties have entered into in this case.

The Court: Let the stipulation be filed and the facts therein set forth will be received in evidence. Now produce your three other exhibits referred to in your stipulation.

Mr. Maiden: Now, if the Court please, at this time in order to complete the stipulation I now offer in evidence as Exhibits Nos. 8-H, 9-I and

10-J, the Corporation Income and Declared Value Excess-Profits Returns filed by the Petitioner for the calendar years 1941, 1942 and 1943, and I ask that the Clerk so mark these exhibits as being a part [57] of the stipulation.

The Court: And the Petitioner joins in this offer of these three instruments?

Mr. Webster: Yes.

The Court: Be sure that the Clerk marks them separately.

Mr. Webster: The 1941 return will be Exhibit No. 8-H.

The Clerk: It has been so marked.

Mr. Maiden: The 1942 return will be marked 9-I?

The Clerk: That has been done.

Mr. Maiden: And the 1943 return will be marked 10-J?

The Clerk: Thank you.

(The documents above-referred to were received in evidence and marked Joint Exhibits 8-H, 9-I and 10-J.)

Mr. Maiden: If the Court please, inasmuch as these are original returns, I would like to have permission—

The Court: Permission is given to substitute photostatic copies.

Mr. Maiden: Thank you.

Mr. Webster: Mr. Simon. [58]

Whereupon,

WILLIAM H. SIMON,

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Please tell us your name.

The Witness: William H. Simon.

Direct Examination

By Mr. Webster:

Q. Mr. Simon, you are in the restaurant business? A. Yes.

Q. And how long have you been in that business? A. Oh, somewhere over 30 years.

Q. Mike Lyman is your brother, is that correct? A. Yes.

Q. And he is in the restaurant business, also? A. He is.

Q. How long has he been in that business? A. Oh, since about 1919.

Q. Have you been in business together? A. Yes.

Q. In what proportion have you shared your business deals? A. 50-50.

Q. What kind of restaurants have you operated? [59]

A. Well, we operate drive-ins, grills, dairy lunch rooms, cafeterias, coffee shops.

Q. When did you first enter the drive-in restaurant business? A. Along about 1935.

Q. Are you familiar with doing business as a corporation? A. Yes.

(Testimony of William H. Simon.)

Q. When did you first commence doing business in corporate form?

A. Ever since we went in business.

Q. Well, now, have all drive-ins in which you have acquired interests been in the corporate form?

A. Yes.

Q. So that at least since 1935—

A. That is right.

Q. —your drive-in restaurants have been in corporation form? A. Yes.

Q. Have your other business ventures involving restaurants been as corporations? A. Yes.

Q. Can you state why you have done business in the corporate form?

A. We try to make each restaurant stand on its own feet. [60] In other words, if it is a separate corporation and if anything should happen to any particular restaurant it doesn't carry down the others, the rest.

Q. That is, you have also adopted a policy, apparently, of having a separate corporation for each restaurant location. A. That is right.

Q. You, Mr. Simon, have formed an opinion, I imagine, as to the safety or riskiness of the restaurant business. Will you kindly state what your opinion of the restaurant business is, in general, from that point of view?

A. It is a very hazardous business, the restaurant business.

Q. Have you ever operated a restaurant which failed?

(Testimony of William H. Simon.)

A. We never operated a restaurant that failed; we close a lot of restaurants.

Q. For what reason?

A. Lack of business, out moded.

Q. Mr. Simon, are you familiar with whether there is a difference between lending to a corporation and buying stock in that corporation?

A. I am.

Q. Would you kindly state what, in your opinion, that difference consists of?

A. Well, when you buy stock in a restaurant, in a corporation, you are subject to just your dividends. That is [61] Number 1. And you just come in as a common creditor; you just come in as a common creditor when you make a loan to a corporation. You don't freeze your money, you become—you are sure of getting your money back. If you don't make profit in that particular restaurant you can get it back out of depreciation.

Q. Let me clarify in my own mind what you stated with respect to your position as a stockholder. As a stockholder what is your understanding of your position in the event that the restaurant which the corporation, of which you are a stockholder,—what your position would be if that restaurant failed.

Mr. Maiden: If the Court please, I think that is an improper question. It calls for a conclusion of the witness on a point that seems to me to be one of law, as to the legal effect of a stockholder.

The Court: Objection sustained.

(Testimony of William H. Simon.)

By Mr. Webster:

Q. Mr. Simon, have you discussed this difference between your position as a stockholder and your position as a lender with your brother Mike Lyman? A. Many times.

Q. In the past it has been stipulated, that is, we have agreed that in the past you and your brother have gone into restaurant ventures in which you have used the form of [62] investing a portion of your money for the purchase of stock and of lending additional money for which you received back promissory notes.

Can you state whether the reason that you went into those deals on that basis was this distinction you had in your mind, which you are talking about?

A. You see, if we loan part of the money to a corporation if anything should happen to that corporation, where it would go broke, then we become a creditor and we get some of that money back as a creditor. If it is stock we just lose our money. We don't have any chance of recovery.

Q. Mr. Simon, did you participate in the formation of Wilshire and Western Sandwiches, Inc.?

A. I did.

Q. When was this deal first talked about?

A. It was in the early part of '41.

Q. Can you relate the circumstances surrounding the original discussions about the drive-in at Wilshire and Western?

A. You mean relative to Carpenter's across the street?

(Testimony of William H. Simon.)

Q. Yes, that is right.

A. Carpenter was operating a drive-in just a block away. It was a pretty old out-moded drive-in. At that time we were figuring on going in with Carpenter and moving the drive-in to the corner of Wilshire and Western, a block [63] up.

As a matter of fact, a lease was negotiated where the landlord was going to spend some seventy-five thousand dollars on the combination drive-in and restaurant and cocktail room. Right before the lease was to be signed Carpenter didn't feel he wanted to operate a combination restaurant. He thought it was a little too big for him. In the meantime I negotiated for the corner of Western and Wilshire, the other corner—what is that, the northwest corner?

Q. That is, the location of the present taxpayer?

A. The present drive-in, yes.

Q. All right.

A. I was going to put a drive-in on that particular corner and Carpenter asked me to let him put a drive-in on that particular corner and forego the other proposition, on account of it being too big.

Q. Now, Mr. Simon, the corporation in question, that is, Wilshire and Western Sandwiches, Inc., was incorporated in March of 1941. It is also stipulated that you signed a lease on this property which you are just talking about.

A. That is right.

Q. In April of 1941?

A. That is right.

Q. Was it your understanding then that the lease would be assigned over to the corporation?

(Testimony of William H. Simon.)

A. Yes.

Q. What was your understanding with respect to who would supervise the construction of the drive-in and operate it?

A. Harry Carpenter.

Q. Did you have any discussions with respect to the capital structure of the corporation?

A. Yes, we did.

Q. When was the first time you spoke about it?

A. Along about April, I should imagine, when we discussed Harry Carpenter taking that particular corner and me assigning the lease to Harry Carpenter.

Q. Who was present at the time of those discussions?

A. There was Harry Carpenter and my brother, Mike Lyman, and M. A. McDonnell.

Q. And yourself? A. And myself.

Q. What was the nature of that agreement or what was the nature of your discussion?

A. We discussed what we thought the costs would run on that particular drive-in, and we thought it would run around \$30,000.00.

At that particular meeting we further discussed that we would invest 50 per cent in stock and make a loan at 50 per cent. [65]

Q. Are you speaking about a formal board of directors' meeting? A. No, informal.

Q. The actual cost was greater or less than your estimate? A. Almost twice as much.

Q. Mr. Simon, with respect to this particular

(Testimony of William H. Simon.)

transaction involving Wilshire and Western, did you have any active part with respect to this decision you have just spoken about going in on a part loan-part stock basis? A. Yes.

Q. What was in your mind at the time?

A. I had other commitments for other restaurants, and I didn't want to freeze all my money in one particular unit. I just wanted to invest about 50 per cent and wanted loans for the other 50 per cent, as I stated before. I could always get my money back if the restaurant wasn't a success, out of depreciation. Then I was a minority stockholder and if I made a full investment I would have to depend on the other stockholders voting a dividend. I didn't want to put myself in that position.

Q. Do you know how much money was paid in by yourself, Mr. Lyman, Mr. McDonnell and Mr. Carpenter during the year 1941?

A. I think it was—I think we paid in \$30,000.00 as [66] an investment and \$25,000.00 as a loan.

Q. What was the total amount that went in?

A. \$55,000.00.

Q. What was the manner in which the corporation evidenced the receipt of this \$55,000.00? Do you understand what I mean?

A. No, I don't quite understand what you are asking.

Q. Did the corporation give you any documents of any kind which evidenced the receipt of money from you? A. No.

Q. Did you receive any stock certificates?

(Testimony of William H. Simon.)

A. No, not at that time. You mean after it was over?

Q. Well, I was speaking—apparently we are not together on the date at which we are speaking.

A. No.

Q. I was talking about the entire year 1941. You have testified that a total of \$55,000 was advanced.

A. That is right.

Q. I asked you whether the corporation issued any kind of documents to either you alone or to all four.

A. Yes, they did. Along about the fall of '41 they issued stock for my 50 per cent that I invested, and give me notes for the 50 per cent representing the loan.

Q. Do you remember how much in stock was given to you?

A. I think I got 500 shares and Mr. Lyman got 500 [67] shares.

Q. Mr. Simon, I show you what purports to be a promissory note of Wilshire and Western Sandwiches, Inc., in the amount of \$4,166.67, dated November 13, 1941. Do you recognize this?

A. Yes.

Q. What was your understanding when you received this note?

A. That it was to be paid back as a loan.

Q. Did this represent in your mind—

A. The moneys I put in.

Q. The moneys you put in? A. As a loan.

Q. What was your intent with respect to the \$4,166.67?

(Testimony of William H. Simon.)

A. That was a loan, I loaned the corporation that.

Mr. Webster: I would like to hand this for marking as Petitioner's exhibit next in order for identification.

Mr. Maiden: I have no objection to its being offered in evidence at this time, if counsel wants to offer it.

Mr. Webster: I do, your Honor.

The Clerk: 11.

The Court: 11, you say?

The Clerk: Yes, your Honor, please.

The Court: Let the instrument just identified by [68] the witness be admitted in evidence as the Petitioner's Exhibit No. 11.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 11.)

By Mr. Webster:

Q. Now, it has been stipulated that of the total moneys which you advanced and that total it has been stipulated is \$9,166.67, a portion of it went in in May or thereabouts of 1941, and some more of it went in later, and a final amount went in in November.

Can you state what your intent was at the time that each of these payments was made?

A. Well, I just took it for granted that 50 per cent was an investment and 50 per cent was a loan.

Q. Did you have in mind exactly 50 per cent, Mr. Simon?

A. At the time we did, yes.

(Testimony of William H. Simon.)

Q. When did the drive-in open at Wilshire and Western? A. Some time in November.

Q. Early or latter part?

A. The early part of November.

Q. When was the decision made as to the amount which would be represented by stock and the amount which would be represented by notes?

A. The final decision?

Q. Yes. [69]

A. I think we had a stockholders' meeting just about that time, or maybe a little after the place opened up; just shortly after.

Q. Pardon me?

A. Shortly after the place opened up.

Q. Who was present at that meeting?

A. Mr. Carpenter, Mr. Lyman, Mr. McDonnell and Mr. Odell, the attorney, and myself.

Q. Where was that meeting held?

A. In my office at 649 South Olive Street.

Q. Mr. Simon, I show you a page titled "Written Consent and Waiver of Notice of Directors' Meeting" which is dated November 13, 1941, and which has on it five signatures. I ask you whether any of these signatures are yours.

A. There is my signature (indicating).

Q. That is your signature? A. Yes.

Q. Do you recollect seeing the pages which are attached to this waiver of notice?

A. Yes, I do.

Q. When did you see those?

A. Well, it was at my office some time in November.

(Testimony of William H. Simon.)

Q. Was it at the time of this meeting about which you are speaking? A. Yes. [70]

Q. These pages which are attached to this written consent and waiver of notice are titled "Minutes of Meeting of Board of Directors of Wilshire and Western Sandwiches, Inc."

These are the pages which were attached (indicating)? A. Yes.

Q. Were these pages prepared at the time you had that meeting? A. Yes, they were.

Q. Who prepared them?

A. Mr. Odell, the attorney.

Q. Do you know under what circumstances these pages were prepared? A. No, I don't.

Q. Are you aware of the contents of these minutes?

A. Several days before this meeting was called in my office I talked to Mr. Carpenter in regard to giving up part of my interest or making a gift of part of my interest and a part of Mr. Lyman's interest to Joe Lerdemer, my general manager. Mr. Lyman and myself, we each gave him 5 per cent of our stock as a gift.

Q. Mr. Simon, I will read a portion of these minutes to you and ask you whether you recall reading this before:

"He—" and the "he" referred to is Mr. Carpenter, the treasurer—"stated that the issuance of this permit [71] had been heretofore brought to the attention of the directors individually and that up to this time the following persons had agreed to take and pay for stock as follows:

(Testimony of William H. Simon.)

“Harry B. Carpenter, 1000 shares, \$10,000.00.

“M. A. McDonnell, 1000 shares, \$10,000.00.

“William H. Simon, 50 shares, \$5,000.00.

“Mike Lyman, 500 shares, \$5,000.00.

“It was further reported that the total cost of said building and equipment and of the improvement of grounds and accessories, in connection with said drive-in sandwich stand, would be in excess of \$55,000.00 and that pursuant to the understanding and agreement between said corporation and said Carpenter, McDonnell, Simon and Lyman, said persons had loaned to said corporation \$25,000.00 in the following proportions:

“Harry B. Carpenter, \$8,333.34.

“M. A. McDonnell, \$8,333.33.

“William H. Simon, \$4,166.67.

“Mike Lyman, \$4,166.66.”

I ask you whether the contents of these minutes, as I have read them now, was a matter which you read yourself previously? A. Yes. [72]

Q. You read those at the meeting which you spoke about? A. That is right.

Q. Which occurred in your office?

A. Yes.

The Court: Don't lead your witness.

Mr. Maiden: Does counsel want to offer that in evidence?

Mr. Webster: Yes.

Mr. Maiden: I have no objection, if the Court please.

The Court: Proceed.

(Testimony of William H. Simon.)

The Clerk: Exhibit 12.

The Court: The minutes, papers attached thereto, identified by the witness, are admitted in evidence as Petitioner's Exhibit No. 12.

(The documents above-referred to were received in evidence and marked Petitioner's Exhibit No. 12.)

By Mr. Webster:

Q. Mr. Simon, did the conversation which you had with Mr. Carpenter a few days previously discuss at all the contents of these minutes?

A. There was something discussed; the general construction of the whole thing, yes.

Q. Did you speak at all about issuing \$30,000.00 of stock? A. No, I don't think so. [73]

Q. You don't remember?

A. I don't remember.

The Court: Don't lead your witness. Your witness said he didn't think so. You prompted him to say he didn't remember. You are going to hurt your own witness and your own case by leading in such a way.

By Mr. Webster:

Q. Mr. Simon, did you ever receive a stock certificate of Wilshire and Western?

A. Yes, I did.

Q. Can you recall when you received it?

A. It was some time in the latter part of November.

Q. Was that the only certificate which you ever received?

(Testimony of William H. Simon.)

A. No. I received one earlier, but then we changed the amount of shares that Mr. Lyman and myself were going to get by giving Mr. Lerdemer a gift of 5 per cent apiece.

Q. Where is the stock certificate which you received? A. In my safety deposit vault.

Q. Has Mr. Lyman received a stock from Wilshire and Western? A. Yes, he has.

Q. Can you describe the circumstances under which he received the stock certificate?

Mr. Maiden: If the Court please, I object to that. [74] I think it would be hearsay. I think Mr. Lyman himself out to testify whether he received any stock and when he received it.

The Court: This witness might have seen it. It wouldn't be hearsay. He is not asking for what was said.

The Witness: It is not hearsay, your Honor.

The Court: Just answer the question. We will pass upon the question, as to whether it is hearsay or not.

The Witness: Yes, I received it from Mr. Lyman.

The Court: Proceed with your examination. The objection is overruled.

The Witness: I received it from Mr. Lyman.
By Mr. Webster:

Q. I didn't hear your answer.

A. I received the stock from Mr. Lyman.

Q. Mr. Simon, can you state whether you intended to purchase stock in Wilshire and Western?

(Testimony of William H. Simon.)

Mr. Maiden: That is a leading question. I object to it.

The Court: In that form it is leading, yes. The objection will be sustained.

By Mr. Webster:

Q. Mr. Simon, when you received the note which has been introduced as Petitioner's Exhibit 11, did you expect that that note would be repaid? [75]

A. I certainly did.

Q. When?

A. I think it was two years from the date.

Q. Mr. Simon, how did you receive the stock and note, did somebody hand it to you, or how did you receive it?

A. Just gave it to me. I was sitting at my desk and they just gave me the stock and a note.

Q. Did you receive the stock and note at the time of the meeting, that you recall?

A. I don't remember.

Q. Can you fix a time when you received the stock and note?

A. I think it was some time in November, the latter part of November.

Q. Mr. Simon, it has been stipulated that on April 21, 1943, a check was issued to you by Wilshire and Western in the amount of \$1,666.16, and that in the voucher portion of the check, that is, in the upper left-hand side was the statement, "Payment on Note." Do you recall receipt of this check? A. Yes, I do.

Q. What did you understand at the time of receipt?

(Testimony of William H. Simon.)

A. It was a repayment on the note, on the loan.

Q. On May 23, 1944, it has been stipulated that you received a check for \$1,667.17, which bore a notation in the [76] voucher portion of that check, that is in the upper left-hand corner, "Note Accounts." Do you remember receiving that check?

A. Yes.

Q. What was your understanding?

A. Repayment of the loan.

Q. It has been stipulated on March 23, 1945, a check for \$833.34 was issued to you marked in the voucher portion of the check, "Balance on Note." Do you remember receiving that check?

A. Yes, I do.

Q. What was your understanding?

A. As a repayment of the loan.

Q. Mr. Simon, I show you a check numbered 2046 bearing the imprint at the lower right-hand corner, "Wilshire and Western Sandwiches, Inc." It is made out to you, dated December 1, 1943, and is in the amount of \$509.31. In the upper left-hand corner is the notation, "Interest to November 3rd inclusive." Do you recall receiving that note?

A. Yes.

Q. What was your understanding at the time?

A. It was interest on the loan.

Mr. Webster: I would like to offer this check as Petitioner's exhibit next in order. [77]

Mr. Maiden: No objection, if the Court please.

The Clerk: Exhibit 13.

The Court: Petitioner's Exhibit 13 is admitted in evidence, being the check just identified by the witness.

(Testimony of William H. Simon.)

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 13.)

By Mr. Webster:

Q. I show you Check No. 4136, bearing the imprint in the lower right-hand corner, "Wilshire and Western Sandwiches, Inc." It is made out to William Simon in the amount of \$113.68. It bears in the upper left-hand corner "Interest on Note to March 24th." Do you remember that check?

A. Yes, I do.

Q. Do you remember receiving it?

A. I do.

Q. What was your understanding at the time of receipt? A. It was interest on the loan.

Mr. Webster: I offer this as Petitioner's exhibit next in order.

The Clerk: 14.

The Court: Petitioner's Exhibit 14 is admitted in evidence.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 14.) [78]

Q. Do you remember any other interest payment? A. I don't remember.

Q. Did you pay anything further into Wilshire and Western Corporation over and above the amounts which we have already talked about?

A. Yes, we did.

Q. When?

A. It was after the place was opened, Carpen-

(Testimony of William H. Simon.)

ter told us that he needed some additional \$10,000.00 to pay all the remaining bills outstanding.

Q. Can you recall more accurately when that was?

A. I imagine it must have been toward the end of November.

Q. Do you identify it as the time when you received the note and stock?

A. No, it was after we received the note and stock.

Q. How long afterwards?

A. Oh, maybe a couple of weeks afterwards; maybe longer. Maybe the first part of December.

Q. Did Mr. Carpenter ask you for any money?

A. Yes, he did.

Q. Do you remember how much?

A. I think if my memory serves me between my brother and myself we put up around a third of \$10,000.00.

Q. And yourself?

A. Half of that amount. [79]

Q. Half of a third? A. Yes.

Q. What did Mr. Carpenter tell you with respect to this money which he asked you for?

A. Well, he says, to loan the corporation this money and he could pay it back in a short time, not to take any notes for it at that time.

Q. Did you expect any interest on that transaction.

A. No, because it was going to be paid back.

Q. Mr. Simon, I show you Check No. 792 bearing the imprint in the lower right-hand corner,

(Testimony of William H. Simon.)

“Wilshire and Western Sandwiches, Inc.” made out to William Simon in the amount of \$1,666.67. In the upper left-hand corner it has the description, “Note Account.”

I ask you if you remember this check.

A. Yes.

Q. Did you receive it? A. Yes.

Q. What was your understanding?

A. Repayment of loan.

Q. Which loan was it a repayment of?

A. Of that last \$10,000.00.

Mr. Webster: I offer this check as Petitioner's exhibit next in order.

Mr. Maiden: If the Court please, it just occurred [80] to me we have been wasting time and we needn't carry this procedure further, because at page 6 of our stipulation we have stipulated on the following dates checks of the Petitioner were issued and delivered to the following named persons in the amounts indicated, with an explanation in the voucher portion of each check as follows, and then it lists each of the charges and the payee.

Mr. Webster: Your Honor, that is certainly true, but there is nothing in the stipulation about the understanding of the recipient of these checks.

The Court: You could at least, considering the state of your stipulation, take the stipulation and ask him his intent on each of these, without putting them in evidence, without taking that much time.

You have agreed that these checks were issued and delivered, each of them. In other words, you

(Testimony of William H. Simon.)

have here about as sufficient a description of each of these checks as you can, I take it.

Mr. Webster: If I may interrupt, I believe counsel for Respondent has made an error. I have not introduced into evidence a single one of these checks set out on page 7, if those are the checks he is speaking of at the moment.

Mr. Maiden: It is my point, your Honor, that is true.

The Court: I was taking you at your word.

Mr. Maiden: Yes, I made a mistake.

The Court: We will be recessed at this time for 10 minutes.

The Clerk: The last exhibit number is 15.

The Court: Exhibit 15 will be admitted in evidence.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 15.)

(Short recess taken.)

By Mr. Webster:

Q. Mr. Simon, in previous deals have you ever used bank loans? A. Yes, sure.

Q. Have you used and are you familiar with doing business with a bank? A. Yes, I am.

Q. Did any discussion ever take place with respect to borrowing from a bank for this transaction?

A. Well, there was some discussion about going to the bank and borrowing this money, and I felt that it was a good loan and paid 6 per cent and

(Testimony of William H. Simon.)

I thought we could use that 6 per cent as well as the bank.

Q. Do you know anything about the books of Wilshire and Western Sandwiches, Inc?

A. No, I don't.

Mr. Webster: That is all. [82]

The Court: Cross examination.

Cross Examination

By Mr. Maiden:

Q. Mr. Simon, I believe the stipulation of facts in the case shows that this Petitioner was incorporated on March 24, 1941. I believe you stated that prior to that time you had discussed with Mr. Carpenter the formation of this corporation for the purpose of building a drive-in restaurant upon some property that you either had leased at the time or intended to lease, is that right?

A. That is right.

Q. I believe the stipulation shows that a lease was to be taken by you on the 26th day of April, 1941. And I believe you testified that it was your intention at the time of obtaining this lease to assign the lease to the corporation.

A. That is right.

Q. It was your understanding that the corporation would then assume, under the lease, the obligations that you yourself had assumed?

A. That is right.

Q. Now, Mr. Simon, I believe you stated that you had been in the restaurant business for some 25 or 30 years. A. Yes.

(Testimony of William H. Simon.)

Q. During that time did you operate drive-in [83] restaurants all the time or a different type of restaurant?

A. No, we have only operated drive-in restaurants since 1935.

Q. Briefly, what is a drive-in restaurant?

A. Well, a drive-in restaurant is a restaurant that an automobile drives on the lot and you serve the customer in the car.

Q. Now, the stipulation shows that in February of 1941 a corporation by the name of Symon's Beverly, Inc. commenced business and that William H. Simon was one of the stockholders in that corporation. That is correct, is it not?

A. That is correct.

Q. The stipulation likewise sets forth the fact that in November of 1941 Simon's Florat, Inc. commenced business and William H. Simon was one of the Stockholders, is that true?

A. That is true.

Q. And William H. Simon is yourself?

A. Yes, sir.

Q. The stipulation further shows that Simon's Five Points, Inc. commenced business on November 1, 1941, and that William H. Simon was a stockholder. That is correct?

A. That is correct.

Q. And that on September 23, 1941, Simon's Washington, [84] Inc. commenced business and that William H. Simon was a stockholder, is that correct? A. That is correct.

Q. And that Sunset Sandwiches, Inc. com-

(Testimony of William H. Simon.)

menced business on January 29, 1941, and that William H. Simon was a stockholder, that is correct?

A. That is correct.

Q. Now, Mr. Simon, when this corporation was set up and a certificate of incorporation was issued to it, you knew at that time that you would be going to build a drive-in restaurant upon this leased property?

A. Will you repeat that question, please?

Q. I say, at the time this corporation received its certificate of incorporation—

A. You mean from the Corporation Commissioner?

Q. —at the time it was incorporated.

A. Yes.

Q. You knew that the corporation would build a drive-in restaurant upon that leased property?

A. That is right.

Q. How much did you estimate at that time the cost of building the drive-in restaurant building would amount to?

A. We figured it would cost about \$30,000.00 for the building and equipment.

Q. How much did you estimate the building by itself [85] would cost you, Mr. Simon?

A. It usually ran about half for the building and half for the equipment.

Q. In other words, you expected at the time of the incorporation of the business that it would cost you approximately \$15,000.00 for the building and approximately \$15,000.00 for the equipment.

A. That is right.

(Testimony of William H. Simon.)

Q. Those two items being essential to the commencement of the business you intended to carry on.

A. That is correct.

Q. Now, I believe, Mr. Simon, that according to the stipulation the Articles of Incorporation authorized capital stock of 7500 shares of common stock of a par value of \$10.00 per share.

I wonder if you provided for the issuance of 7500 shares at \$10.00 a share, which would be \$75,000.00?

A. I really don't know. I can't answer that.

Q. Would you say it was your intention at that time to invest \$75,000.00 in this business?

A. No, possibly—

Q. If it became necessary.

A. Possibly not.

Q. Was that just some figure you pulled out of the air, 7500? [86]

A. I can't answer that question.

Q. Now, the stipulation shows that on July 10, 1941, a building construction contract was entered into between this Petitioner and Frank A. Woodyard, under which Mr. Woodyard contracted to construct a drive-in building for the sum of \$22,651.00. That would indicate that as of July 10, 1941, you knew that the building alone would cost you a minimum of \$22,651.00, isn't that correct?

A. That is correct.

Q. And at that time, I believe, from your direct examination no shares of stock had been issued by the corporation?

A. That is correct.

Q. Then wasn't it apparent to you stockholders

(Testimony of William H. Simon.)

or incorporators on July 10, 1941, that the corporation would have to have at least \$37,651.00 in order to build its building and equip it for business, is that correct?

A. No, I don't know whether it is or not. If you say that building contract was twenty two thousand some odd dollars, it would cost more than \$37,000.00, the way I figure the thing. It would cost 50 per cent for building and 50 per cent for equipment.

Q. In other words, as of July 10, 1941, since your building contract called for \$22,651.00, you knew that your equipment would cost approximately the same amount, is that [87] right?

A. That is right.

Q. Now, the stipulation in this case further shows that on July 14, 1941, an application was filed with the Corporation Commissioner to permit the sale, the issuance and sale of the Petitioner's stock to yourself and your brother, Mike Lyman. Is he your brother?

A. Yes, sir.

Q. And Mr. Harry B. Carpenter and M. A. McDonnell and Harry B. Carpenter Jr. And that you asked at the time for permission to sell for cash \$15,000.00 worth of this stock or 1500 shares.

And you further asked permission to issue additional shares for the purpose, if necessary, of furnishing the corporation sufficient money to complete its drive-in building and equip it for opening business.

Now, Mr. Simon, how much money did you intend to invest in this corporation?

(Testimony of William H. Simon.)

A. Originally we intended to invest, the group, \$15,000.00 and loan \$15,000.00.

As we progressed we intended to advance this money on the same ratio of 50 per cent investment and 50 per cent loan.

Q. Well, you intended or thought at least that you might issue sufficient stock for cash to pay the entire cost of building the drive-in restaurant building and equip it for business, isn't that true?

A. No, I don't think so. I don't think that was ever true.

Q. Do you realize that such a provision as that is actually in the application which you filed with the Corporation Commissioner for issuance of stock?

A. I don't remember.

Q. If such a provision as that is in the application, you don't deny its veracity?

A. I beg your pardon?

Q. If such a provision as that is in the application, then, of course, you don't deny it?

A. I don't know. I don't run my business. I know what my intentions were and I don't—I am not a lawyer, I don't go over stock applications and books. I am not a lawyer nor an auditor. You might be right. I don't know whether you are not. I know what my intentions were at the time and that is all I can testify to.

Q. Now, Mr. Simon, the stipulation shows that between June 9, 1941, and November 13, 1941, that you and Mr. Lyman had advanced certain money to the corporation. Now, will you please explain to the Court why it is that in return for the money

(Testimony of William H. Simon.)

advanced by you you took capital stock for only half the amount and instruments in the [89] form of promissory notes for the other half?

A. At the start of this particular proposition, when we had an informal meeting, it was agreed at that time that we would invest 50 per cent and take 50 per cent in notes as loans. As I testified earlier, I didn't want to freeze too much money in that particular unit. I had other commitments and I didn't want to come in there just as a stockholder, I wanted to come in there partially as a stockholder and partially as a creditor. One, I could get my money back faster even if the place wasn't a success. I didn't have to wait for dividends to be earned to get my money back that way. I could get it back out of the depreciation.

No. 2, if the place would fail, I became a common creditor.

Q. What do you mean by getting your money out of depreciation?

A. As a loan, when it was set up as a loan, the place didn't have to make a loan—money to meet the loan every month and they depreciate the place over a 10-year period. If the place didn't make money there was enough money from depreciation to pay back those loans.

Q. Do you mean the company set up a cash reserve each month for depreciation?

A. Every corporation depreciates their investment.

Q. Did this corporation actually set aside and earmark [90] cash money for depreciation?

(Testimony of William H. Simon.)

A. According to the law, as I understand it, the tax law, you can depreciate 90 per cent of your investment to be depreciated over a period of 10 years. If you have a 10-year lease you can depreciate it over a period of 10 years. You can depreciate that monthly.

Q. How was that going to return your cash money to you, is what I don't understand, Mr. Simon.

A. Well, as the investment is depreciated that money accumulates.

Q. How did you expect to be repaid for these loans, except out of the current earnings of the business?

A. You don't have to have current earnings to be paid back on a loan.

Q. How would the corporation pay you back on the loan if it did not make any money?

A. You have a depreciation account they could use. You are depreciating your investment.

Q. What was the cost of the building? I believe the stipulation shows that. \$40,489.68.

Suppose the corporation didn't make sufficient money to set up a depreciation reserve, how then did you expect to get the return of cash money from your loan?

A. You mean if they lost money?

Q. Yes. [91]

A. If they lost beyond their depreciation account, well, I would just have to come in as a creditor.

Q. In other words, this corporation, you had to

(Testimony of William H. Simon.)

realize this corporation had to make money before you could expect the payment back of your loan?

A. No, I didn't realize that. I don't know that. I don't think that is a bit necessary.

Q. Well, suppose the corporation hadn't made any money.

A. And if they didn't lose any money?

Q. Suppose they didn't make any money and actually lost money.

A. Well, that would be too bad. I would lose my money.

Q. In other words, you knew that your loan was just as good as the company's ability to make money, is that right?

A. That is right.

Q. Now, what difference actually would it make to you, Mr. Simon, whether or not you had your entire advancement in capital stock rather than part in capital stock and part in a loan?

A. I explained that. I didn't want to freeze my money, the whole amount, as an investment. The restaurant business is a very hazardous business and I wanted to protect my money. I only wanted 50 per cent in stock and I wanted to [92] make a loan of the other 50 per cent, so if the place did go broke I would become a creditor and I would recover some of my money. If I was a stockholder I would lose it all.

Q. Now, Mr. Simon, since you say the restaurant was such a hazardous business, why were you willing to risk your own cash money in addition to the amount you say you were willing to subscribe for stock?

(Testimony of William H. Simon.)

A. You mean after the place was opened?

Q. Yes. A. The last \$10,000.00?

Q. No. I am talking about the amount of money you advanced to the corporation.

A. You mean the 50 per cent?

Q. Yes. A. I am used to gambling.

Q. I believe you stated you didn't want to go to the bank and get the money because you felt like you thought it would make money.

A. That is right.

Q. A safe loan.

A. That is right. I wanted that 6 per cent.

Q. You wanted that 6 per cent. Now, Mr. Simon, I am going to ask you a direct question and I would appreciate a direct answer. Was this arrangement conceived and carried through for the purpose of being able to get a return of a [93] portion of the money advanced to this corporation, without having to pay any tax on it and in order to allow the corporation to take a deduction out of current earnings for interest?

A. Positively not.

Q. Mr. Simon, did you take into consideration the tax benefits that would be derived by you and the corporation by treating part of this money as a loan, rather than as an investment?

A. I would say yes.

Q. So then the tax benefit was taken into consideration in this arrangement?

A. No, no, not wholly.

Q. You said that it was considered.

A. You asked me a direct question and I an-

(Testimony of William H. Simon.)

swered you direct. Then you asked me another question and I answered you. No.

Q. Well now, you stated that that was the tax benefit that was taken into consideration.

A. You asked me if I knew whether there was a tax benefit, sir, and I said I did. Then you asked me a question whether I took that into consideration at the outside, when we discussed this proposition, and I says no. It was a policy that we pursued.

Q. In other words, you knew that there was a tax [94] benefit to be derived by you and the corporation, but you deny that that knowledge in any way influenced this arrangement.

A. That is right, sir.

Q. In other words, you weren't interested in obtaining any tax benefit.

A. At the time I was only interested in protecting my capital.

Q. Now, Mr. Simon, the stipulation shows that you incorporators advanced \$55,000.00 to the corporation prior to its commencement, actual commencement of business. Was that \$55,000.00 an essential expenditure in order to permit this Petitioner to open for business? A. Yes.

Mr. Webster: May I interrupt, your Honor? I would like that question read.

The Court: Read the question.

(The question was read.)

Q. (By Mr. Maiden): Now, Mr. Simon, I want to call your attention to page 9 of the stipulation that we have entered into, and just for your

(Testimony of William H. Simon.)

benefit to yet you see exactly what I am talking about, I want to read you this Paragraph 16 which says, "The stockholders of Petitioner, or some of them, have entered into similar transactions wherein they advanced money to [95] other corporations for a portion of which they received capital stock thereof and for the balance of which they received documents designated 'promissory notes'" and then it gives a list of some nine such corporations. I call your attention to the M & S Foods, Inc., which shows that the stockholders received \$36,000.00 in stock and received instruments designated promissory notes in the amount of \$108,000.00. What is your explanation for that situation?

A. I can't give you any explanation of it.

Q. Can you tell the Court why it is in all of these other corporations of which you were an incorporator and stockholder that the advancements made to the corporation were discharged by the corporation by issuance partially of stock and the balance in notes?

A. I couldn't go into those things intelligently at the present time.

Q. Was the arrangement in these other corporations prompted by the same motive you had in the instant case?

A. I can't answer that intelligently, sir.

Q. How can you answer it?

A. I can't answer it at all.

Q. In other words, you have no explanation to offer as to why in all these other corporations this same arrangement was put into effect?

(Testimony of William H. Simon.)

A. I wouldn't care to answer. I couldn't give you [96] an intelligent answer at the present time.

Q. Now, Mr. Simon, I call your attention to Petitioner's Exhibit 11 which has been identified as a note given to you by this Petitioner, in return for \$4,166.67 of the total advance made by you to the Petitioner. Was it your intention at the time this note was executed to demand payment of that note at its due date, regardless of the financial condition of the corporation at the time?

A. That is right.

Q. It was? A. Yes, sir.

Q. Even though it meant the liquidation of the business?

A. I don't suppose so. I would be very fair about it.

Q. In other words, you would not have insisted upon the payment of this note at its due date if it meant a financial hardship to the business?

A. No, I don't suppose I would.

Q. It was your intention or thought that you would receive payment of this note out of the current earnings of the business?

A. Yes, sir.

Q. There wasn't any question of you and the other gentlemen interested in this corporation not having enough cash money to pay the costs incident to the opening of the business? [97]

A. Well, I can only answer that for myself, sir.

Q. Well? A. I had money.

Q. You had plenty? A. Yes, sir.

(Testimony of William H. Simon.)

Q. Could you have financed the entire opening cost of this business, if necessary?

A. I don't think so, not at that time.

Q. But you could have purchased the four thousand odd dollars shown on that note in shares of stock of the company, isn't that right?

A. I think the record show that, sir.

Q. Can you explain to the Court why it was, Mr. Simon, that the notes issued by this corporation were in direct proportion to the shares of stock issued by the corporation?

A. Well, originally when we had this informal meeting we arbitrarily thought that was a fair division, 50-50.

Q. I believe you stated that you don't know anything about the books of the corporation.

A. That is right, I do not, sir.

Q. Did you sign any income tax return for the corporation?

A. I don't think I ever did, no; at least. I don't think so.

Q. In these other corporations that are set out in the [98] stipulation, which I have called to your attention, did you hold any official position with any of those corporations? F & LB Corporation?

A. I might be an officer in this corporation (indicating).

Q. Were you a member of the board of directors? A. I think so.

Q. What about F & S Foods, Inc.?

A. I think so.

(Testimony of William H. Simon.)

Q. A member of the board of directors and an officer? A. Yes.

Q. What about Carsim, Inc.?

A. I think I am president there.

Q. I will ask you to look at the other corporations and state whether or not you were an officer and member of the board of directors.

A. Officer (indicating); officer (indicating); officer (indicating); officer (indicating); nothing there, I don't think (indicating).

Q. You were not an officer of Sunset Sandwiches, Inc.? A. No.

Q. Were you a member of the board of directors?

A. I don't think so. I don't know. I can't tell you for sure. I had nothing to do with that.

Q. You had nothing to do with Carleton's, Inc.?

A. No, sir.

Q. But you stated on direct examination, I believe, that one reason why you wanted part of your advances to be treated as loans was because you were a minority stockholder and you were afraid that dividends might not be declared often enough to suit you, is that right?

A. Well, being a minority stockholder I had no control over that corporation.

Q. You were in business with the majority stockholders in this corporation, in these other corporations that we talked about, weren't you?

A. Some of them, yes.

Q. You and Mr. McDonnell and Mr. Carpenter

(Testimony of William H. Simon.)

and the other gentleman named in these other corporations, I take it, are close personal friends.

A. Yes, sir.

Mr. Maiden: I believe that is all, if the Court please.

The Court: Are there any further questions?

Mr. Webster: Yes, your Honor.

Redirect Examination

By Mr. Webster:

Q. Mr. Simon, with respect to the corporations whose names appear in the stipulation at pages 8 and 9, which was shown to you previously by Mr. Maiden, this stipulation shows [100] that capital structure of each of those corporations was represented in part in the form of stock and in part in the form of notes. I am addressing my question now not to the actual division in dollars between stock and loans, I am simply addressing my question now to the fact there was a division in the first place between stock on the one hand and loans on the other.

A. That is right.

Q. I ask you whether you know what the reason for that division was.

A. Well, I imagine it would carry through for the same reason——

Mr. Maiden: Your Honor, I believe the witness stated on direct examination he couldn't answer such a question as that intelligently, and he didn't care to make any statement about it.

Mr. Shearer: The question, if your Honor

(Testimony of William H. Simon.)

please, on cross examination to which counsel refers, referred to specific figures.

Each question directed the witness' attention to whatever the amount of dollars was in stock and whatever the amount of dollars was in loans. That is not the same question as the question here presented, if your Honor please.

Mr. Maiden: I did ask him if he could explain why it was that the same arrangement was used in these other [101] corporations as was used in this instant case.

The Court: Read this present question.

(The question was read.)

The Court: I think it is true the question was asked the witness on direct examination and he stated he couldn't and didn't care to answer the question; he couldn't answer it intelligently. However, I am not going to sustain the objection. The objection is overruled. Proceed.

The Witness: Well, as I said, I imagine the same arrangement was carried through for the same reasons on these corporations as on this corporation in question here. [102]

By Mr. Webster:

Q. Mr. Simon, on cross examination you were asked as to why, in the case of Wilshire and Western Sandwiches, the loans were made in proportion to stockholdings. It is my understanding that your answer was not exactly directed to the question. Would you give us the answer now to that question?

(Testimony of William H. Simon.)

A. Well, it was at an informal meeting when we first contemplated this venture. We agreed on whatever moneys we put up, that fifty percent would go for stock as an investment and fifty percent toward a loan.

Q. Mr. Simon, I see where this misunderstanding possibly arises. I think what counsel for Respondent means was if you took one third of the stock, you and your brother took one third of the stock, did you make one third of the loans?

A. Yes, we did.

Q. Can you give a reason for why that took place?

A. I don't understand what—will you repeat that, please? I don't understand it.

Q. You and your brother together took thirty-three and a third percent of the stock. You made thirty-three and a third percent of the loans, and the question is this: Since you took one third of the stock and made one third of the loans and since Mr. Carpenter took one third of the [103] stock and made one third of the loans and Mr. McDonnell took one third of the stock and made one third of the loans, what was the reason for that kind of proportion?

A. Well, my brother and myself are always considered one unit.

Q. Mr. Simon, on cross examination you were asked as to whether the fact that as a minority stockholder you do not have control over the declaration of dividends was the reason for your going into this part loan-part stock setup?

(Testimony of William H. Simon.)

A. No, not wholly.

Q. That is what I wanted to know. Was that the sole reason? A. No, no, no.

Q. Mr. Simon, do you recall any instances when you had differences of opinion with Mr. Carpenter or Mr. McDonnell on business matters?

A. Nothing serious.

Mr. Webster: That is all, your Honor.

Mr. Maiden: No further questions, if the Court please.

The Court: I want to ask the witness one question.

By the Court:

Q. I have before me here in this stipulation, Mr. Witness, a list of corporations, other corporations about which you have been asked. I merely wanted to ask you [104] whether you were a majority stockholder in any of those. A. No, sir.

Q. Were you a minority stockholder in each of them? A. Yes, sir.

Q. I will ask you this further: Were you and your brother together—you spoke of your brother and you being a unit in these matters—were you and your brother, taken together as a unit, always in the minority in these corporations?

A. In the Simon corporations we were in the majority.

Q. Which one was that?

A. Simon's Florat, Simon's Washington, Simon's Five Points.

(Testimony of William H. Simon.)

Q. These with the word "Simon's" in the title of the corporation, you were in the majority?

A. Yes, sir.

Q. When you were in the majority, you put your name in the corporation, is that right?

A. Yes.

Q. When you and your brother were in the majority? A. That is right, sir.

The Court: That is all I want to ask.

Mr. Maiden: I want to ask one further question, if I may.

The Court: Proceed. [105]

Recross Examination

By Mr. Maiden:

Q. Mr. Simon, I will ask you if it isn't a fact that in each of these corporations, other than the corporation that we are now trying in this matter and with the exception of Carleton's, Inc., wherein you do not appear to have been a stockholder, if the moneys advanced to these corporations were not the moneys needed by the corporations to pay for their buildings and equipment preparatory to opening for business.

A. I imagine.

Mr. Maiden: That is all, if the Court please.

Mr. Webster: That is all, your Honor.

The Court: This witness is being excused by both sides, is he?

Mr. Maiden: Yes, sir, so far as I am concerned.

Mr. Webster: Yes, your Honor.

The Court: You are excused from further attendance.

(Witness excused.)

The Court: Before you start interrogating the next witness, let me inquire in a general way how much longer you expect to take. I am not hurrying you, but I want to get a general idea of how much longer you expect to take.

Mr. Webster: I imagine on direct about two hours.

The Court: Proceed. [106]

Whereupon,

HARRY B. CARPENTER

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Tell us your name, sir.

The Witness: Harry B. Carpenter

Direct Examination

By Mr. Webster:

Q. Mr. Carpenter, you are in the restaurant business? A. Yes.

The Court: It might be of some convenience to some of your witnesses to say I shall not sit more than a few minutes after 5:00 o'clock. If you think you are going to take that much time for this witness, you may excuse the others.

Mr. Maiden: May I speak to one of my witnesses?

The Court: Yes.

Mr. Maiden: If the Court please, I have a request to make at this time of the Court and of counsel. I have present a witness who will not be available to me tomorrow. It would only take about 10 or 15 minutes for my direct examination of him. I would like to put him on now out of order.

The Court: What does the Petitioner say? [107]

Mr. Shearer: No objection.

Mr. Webster: That is all right.

The Court: Very well. Withdraw this witness, then, and put on the witness for the Respondent out of order.

(Witness withdrawn.)

The Court: If you are going to take 10 or 15 minutes, we might take some testimony from this witness later, although I think probably not. The other witnesses, besides the one that is going on the stand now and the gentleman who has just been on the stand, Mr. Carpenter, may be excused if they wish until 10:00 o'clock tomorrow morning.

Whereupon,

BENJAMIN H. WHITTAKER

called as a witness for and on behalf of the Respondent, having been first duly sworn, was examined and testified as follows:

The Clerk: Tell us your name.

The Witness: Benjamin H. Whittaker.

Direct Examination

By Mr. Maiden:

Q. What is your business, Mr. Whittaker?

A. Certified public accountant.

(Testimony of Benjamin H. Whittaker.)

Q. How long have you been a certified public accountant? A. About 25 years. [108]

Q. Where have you practiced your profession?

A. Since World War I, in Los Angeles.

Q. Mr. Whittaker, are you acquainted with Mr. Carpenter and Mr. Simon?

A. Not with Mr. Simon, but with Mr. Carpenter, yes.

Q. Was that the Mr. Carpenter who was just sworn in as a witness previous to your taking the stand? A. Same one.

Q. Have you ever heard of the Wilshire and Western Sandwiches, Inc., corporation?

A. I have.

Q. When did you first become acquainted with that corporation? A. In '41.

Q. Will you briefly state how you became acquainted with the corporation?

A. I was connected with Mr. Carpenter with his taxes. This new corporation was formed, and Mr. Carpenter came to my office and asked me to outline a set of records for his bookkeeper to install and use.

Q. Do you recall whether or not his first visit to you after this corporation had been formed?

A. Oh, yes, it was after.

Q. You say he came to you for the purpose of what?

A. Having a set of books outlined and set up to be [109] used for the corporation.

Q. What did you do, Mr. Whittaker?

A. I first of all asked Mr. Carpenter for a copy

(Testimony of Benjamin H. Whittaker.)

of the minute book, and so forth, which I received from Mr.— the attorney.

Q. In point of time, will you tell the Court when that was? A. Yes. It was in October.

Q. Of what year? A. 1941.

Q. Did you receive a copy of the minutes of the corporation?

A. The minute book itself was sent over to me by Mr.—

Q. Was it Mr. Odell?

A. Mr. Odell, yes, October 23rd. I asked him to deliver to my secretary the books of the Wilshire and Western Sandwiches, Inc., as per our telephone conversation, “and will return them to you shortly.” He sent them over.

Q. Will you briefly explain why it is you wanted the minutes of the corporation for the purpose of setting them up some books?

A. Because I wanted to prepare an opening journal entry, which would give the date of incorporation and the capital stock and how it was divided, and its permit from the Corporation Department, and who the first officers were, and [110] the question of a lease also came up.

Q. Now, then, did you prepare a set of books or just an outline as to how the books should be set up?

A. I sent them an index for the books and a copy of the opening journal entry, of what I had prepared there.

Q. Now, the outline or list of records that you

(Testimony of Benjamin H. Whittaker.)

sent the corporation, did it include an account for notes payable? A. It did.

Q. Did the opening journal entry that you sent them provide that the corporation was incorporated with a capital of \$75,000.00? A. It did.

Q. Divided into 7,500 common shares of \$10.00 each par value? A. That is correct.

Q. Did it likewise recite the fact that the company had received permission from the Corporation Commission to issue 7,500 shares of its common stock for cash to Harry B. Carpenter, M. A. McDonnell, William H. Simon, Mike Lyman, and G. C. Jobson? A. Or to any or all of them.

Q. At the time you examined those minutes, did you carefully read those minutes?

A. I wouldn't say that I scrutinized them closely. I looked through them for anything that might affect their [111] financial books.

Q. Now, Mr. Whittaker, did you keep the books of this corporation? A. No.

Q. Do you know who kept the books of the corporation?

A. A Mrs. Jennings, I think, is her name.

Q. She was an employee of the corporation?

A. She was an employee of the corporation, of Mr. Carpenter's; all of Mr. Carpenter's interests.

Q. Now, did you prepare the 1941 corporation income and excess profits tax return for this corporation?

A. The income, yes. There was no excess profits tax prepared.

(Testimony of Benjamin H. Whittaker.)

Q. Is this the 1941 return prepared by you, Mr. Whittaker (indicating)?

A. Yes, that is my signature.

Q. In preparing that return, what investigation did you make or have made of the books and records of the corporation for the year 1941?

A. I took a trial balance of the books.

Q. When was that trial balance taken, Mr. Whittaker, would you say?

A. Some time after the 15th of January, between that time and the 7th of March.

Q. 1942? [112] A. 1942.

Mr. Maiden: I believe this return for 1941, which is Joint Exhibit 8-H to the stipulation, if the Court please, shows that it was sworn to on the 11th day of March, 1942.

The Witness: Yes.

By Mr. Maiden:

Q. And was signed by you as the person preparing the return on the 11th day of March, 1942?

A. That is correct.

Q. Now, referring you to the return, does the balance sheet appearing on page 4 of this return—

A. Yes.

Q. —is that the same as the trial balance you had taken off the books? A. Yes.

Q. Of the corporation? A. It is.

Q. Now, will you explain what the books showed as of December 31, 1941, with respect to the capital structure of the corporation?

A. The books showed a capital stock of \$75,-

(Testimony of Benjamin H. Whittaker.)

000.00, of which \$55,000.00 had been set against an account which read "Cash Special \$55,000.00."

Q. Did the books as of December 31, 1941, show any notes payable to the stockholders? [113]

A. No.

Q. Now, this 1941 return, being Exhibit 8-H, shows the capital stock subscriptions of \$55,000.00. Is that the way the books were as of December 31, 1941?

A. That is. That is covered in that Cash Special Account of \$55,000.00.

Q. Now, Mr. Whittaker, was the matter of the organization of this corporation discussed with you by Mr. Carpenter at any time prior to its organization? A. No.

Q. Did you have any discussion with Mr. Carpenter after he came to you for the purpose of having you prepare them a set of books relating to the manner in which the advances made to this corporation would be handled?

A. No, that was not taken up with us.

Q. He didn't tell you that part of the advances were to be treated as loans?

A. Not to my recollection.

Mr. Maiden: I believe that is all, if the Court please.

The Court: Cross-examine.

Cross Examination

By Mr. Webster:

Q. Mr. Whittaker, you have testified that you say the minute book of Wilshire and Western on

(Testimony of Benjamin H. Whittaker.)

October 23, 1941. Did [114] you see it after that date?

A. No. After I had gotten the data from it, I sent it back to Mr. Odell across the street.

Q. Did you ever see any minutes which were later included in the minute book?

A. No, I did not.

Q. Did you ever see any of the stock certificates which were issued by the corporation?

A. No.

Q. Did you ever see any of the notes which were issued by the corporation? A. No.

Q. Mr. Whittaker, in the minutes of the corporation dated July 14, 1941, there is a statement that a portion of the money desired by the corporation would be borrowed. Do you recollect seeing that statement? A. I do not.

Q. You have testified that when you set up the books of account of the corporation you included a notes payable account, is that correct?

A. Yes, of course.

Mr. Webster: Mr. Maiden, will you stipulate I have here the ledger, the general ledger, of Wilshire and Western Sandwiches, Inc.?

Mr. Maiden: So stipulated. [115]

By Mr. Webster:

Q. Mr. Whittaker, I ask you to find for me, if you can, the account titled "Notes Payable."

A. I can't find any accounts in there of any sort or description. I gave them a list of the accounts to be set up, and if they didn't set them

(Testimony of Benjamin H. Whittaker.)

up, it is not my fault. Where it should be, I can point out to you. It should have been in between this point and that point (indicating).

Mr. Maiden: What pages did you refer to, that it should be in between one point and another point?

The Witness: It is not numbered. They did not follow out my numbering.

By Mr. Webster:

Q. In any case, it would have been in the liability section?

A. It should have been in the liability section. It should have been, it was provided for.

Q. After you gave instructions with respect to the opening of the books of account, did you see the books again?

A. I probably saw them in January when they had that trial balance taken off.

Q. Did you take the trial balance?

A. No; my assistant did.

Q. An employee of yours?

A. He happened to be my son. [116]

Q. No relation, in any case, to Wilshire and Western Sandwiches? A. I beg pardon?

Q. He had no affiliation with Wilshire and Western Sandwiches, Inc.?

A. Scarcely, if he was working for me.

Q. Mr. Whittaker, have you in your possession a copy of the information which you submitted to the bookkeeper at Wilshire and Western at the time they set their books up?

(Testimony of Benjamin H. Whittaker.)

A. Why, sure. They had this index and this information, an opening journal entry. These are just the footnotes from which this was dictated (indicating).

Q. Mr. Whittaker, you are showing me now your carbon copy of that portion of the general ledger which appears under the tab, "Journal," and appearing on pages 1 and 2 of that journal.

A. That was typed in my office.

Q. That was typed in your office?

A. That was typed in my office.

Q. And this was approximately at what time, what date?

A. It would have been some time shortly after October 23rd.

Mr. Maiden: 1941?

The Witness: 1941. I might add it is my general practice, in a case of that kind, to provide that opening [117] journal typed in connection with the layout.

By Mr. Webster:

Q. Mr. Whittaker, I point to Account No. 1032, entitled "Stock Subscriptions Receivable," contained under the tab "Assets" in the general ledger of Wilshire and Western. I will ask you whether you have ever seen this page before (indicating).

A. No. The heading seems to have been written in at my office.

Q. You say the heading was written at your office? A. Yes.

Q. Under the column "Date" appears "Decem-

(Testimony of Benjamin H. Whittaker.)

ber 31, 1941" for the first entry, and the posting reference to "J-3" and "ACF \$55,000.00." Turning to J-3, I ask whether you have ever seen the contents of that entry.

A. I have never seen that page before.

Q. Is the handwriting familiar?

A. I don't know whose handwriting it is. It is not from my office; we type everything.

Q. Did you ever give any instructions to anyone at Wilshire and Western with respect to the amount of stock either subscribed for or unsubscribed for?

A. The only instruction that I ever gave to anybody there was that contained in that opening journal entry, which you have typed in the books, the journal that you just showed [118] me.

Q. Mr. Whittaker, in the event that you had seen or had been shown a copy of the notes and the stock certificates prior to December 31, 1941, would you have made any entry on the books?

A. I would not have made any entry on the books of any sort or description.

Q. Would you have given anybody an instruction to make an entry on the books recording the existence of the notes and stock?

A. Yes, I think I would.

Q. Mr. Whittaker, what source did you use to prepare the 1941 tax return?

A. My trial balance taken right from the books.

Q. In the event that the books were incorrect—

A. I was not making an audit. I was preparing a tax return.

(Testimony of Benjamin H. Whittaker.)

Mr. Webster: That is all, your Honor.

The Court: Anything further from this witness?

Mr. Webster: Just a minute.

By Mr. Webster:

Q. Mr. Whittaker, in the event the books were incorporated, would your tax return have been incorrect?

A. It depends when the entries on the books were made. The entries that were on the books when I took the trial [119] balance and had my son work on the trial balance were the ones on which the tax return is made.

Q. But if, in fact, the books were incorrect—

A. You mean out of balance? What do you mean by “incorrect”?

Q. If the books did not accurately reflect the financial position or stock structure of the corporation, then the tax return would likewise not reflect the actual financial position or actual stock structure of the corporation?

A. I don't think that follows at all.

Mr. Webster: That is all, your Honor.

Redirect Examination

By Mr. Maiden:

Q. Mr. Whittaker, when you prepared the 1941 return did you turn it over to Mr. Carpenter?

A. I don't recall whether I did that or whether I sent it up to his office for him. I think my general practice at that time was to send all of them up to Mr. Carpenter's office.

(Testimony of Benjamin H. Whittaker.)

Q. This return shows it was signed by Harry B. Carpenter and H. B. Carpenter, Jr.

A. Yes.

Q. Did either of those officers object to this return as prepared by you?

A. No. I think about what happened was this: that I took the returns up there and I said, "You sign here," and [120] they signed there and put the seal on, and I took it away and signed it myself, and mailed it up to the Division.

Q. You don't know whether they read the return or not?

A. I don't think so. Not very many, none of my clients ever read their returns. The only thing they want to know is, "How much tax do I have to pay?"

Mr. Maiden: No further questions.

Mr. Webster: No further questions.

(Witness excused.)

The Court: We will be recessed until 10:00 o'clock tomorrow morning. Let the record be definite that this witness is excused from further attendance. Is that right?

Mr. Webster: Yes, that is right.

Mr. Maiden: That is right.

(Whereupon, at 5:00 o'clock p.m., an adjournment was taken until 10:00 o'clock a.m., Thursday, December 4, 1947.) [121]

Los Angeles, Dec. 4, 1947

PROCEEDINGS

The Court: Proceed.

The Clerk: The witness taking the stand is Mr. Harry B. Carpenter, who has been sworn.

Whereupon,

HARRY B. CARPENTER,

called as a witness for and on behalf of the Petitioner, having been previously duly sworn, resumed the stand and testified further as follows:

Direct Examination (Continued)

By Mr. Webster:

Q. Mr. Carpenter, you testified yesterday that you had been in the restaurant business for approximately 40 years. A. Correct.

Q. How much of that time in this area?

A. Since 1916.

Q. Southern California? A. That is right.

Q. What type of restaurants did you operate?

A. I formerly operated small lunch counters, seating 12 to 25, until 1930, when I opened my first drive-in, February of 1930.

Q. Since that date what type of restaurants have you operated?

A. After disposing of my lunch counters in 1930, the [125] latter part of '30, I have operated nothing but drive-ins.

Q. Do you operate these drive-ins completely?

A. No.

(Testimony of Harry B. Carpenter.)

Q. That is, by yourself? A. No.

Q. You share the ownership with others?

A. That is right.

Q. At the present time approximately how many drive-ins do you have an interest in?

A. Eight to ten.

Q. These drive-ins are located at different locations? A. Yes.

Q. Do you have the same or a different business unit operating those drive-ins, each of them?

A. They are all separate.

Q. All separate business units?

A. All operated separate. The ones under my supervision have one joint office.

Q. But the corporation or the business unit which owns those drive-ins is different for each drive-in? A. That is correct.

Q. Are those business units partnerships or corporations?

A. Two partnerships and two corporations.

Q. Well, now, you have— [126]

A. I am speaking of the ones I supervise.

Q. With respect to the remaining ones in which you have an interest—

A. They are all corporations.

Q. When did you first enter into the corporate form of doing business?

A. To the best of my recollection, 1938.

Q. Prior to that time you did business in what form? A. Partnership.

Q. Subsequent to that date as a corporation?

(Testimony of Harry B. Carpenter.)

A. Both, both corporation—

Q. Permit me to clarify that question. With respect to new ventures started after 1938—

A. All corporations.

Q. Is there any reason for the fact that subsequent to 1938 any new ventures were in corporate form?

A. Yes. Prior to '38 I would take a lease on a corner and in every instance there was a kick-off clause.

Q. What do you mean by “kick-off” clause?

A. Both the landlord or myself had the privilege of giving 60 to 90 days' notice in canceling the lease. It was restricted on the landlord's part to sale or long-term lease of his property. I had the privilege, for any reason whatsoever, of giving 60 to 90 days' notice, as the case might be, in folding up and moving off. [127]

Q. By the way, Mr. Carpenter, when you speak of you, yourself, having that privilege, you are speaking with respect to the business organization in which you had an interest?

A. That is right.

Q. You say you had this kick-off clause prior to 1938?

A. That is right.

Q. Did anything occur which prevented you from getting that clause after that date?

A. It became harder and harder to get a good corner, as the valuation of the property went up, without signing a direct lease.

Q. How long term of lease would customarily

(Testimony of Harry B. Carpenter.)

be required? A. Ten to fifteen years.

Q. Did this fact you would have to sign a long-term lease, without a privilege of cancellation, have any effect upon your decision to go into a particular location as a corporation?

The Court: Counsel, I call your attention to the fact the witness has not stated he wouldn't have thereafter the privilege of cancellation. That is a kind of inference. It has not been stated. I couldn't consider this evidence.

By Mr. Webster:

Q. Mr. Carpenter, subsequent to 1938 did you ever enter [128] into any leases? Did you, or any business unit in which you had an interest, ever enter into any leases which did have the right of cancellation about which you previously spoke?

A. After 1938?

Q. Yes. A. No.

Q. They were all long-term leases?

A. That is right.

Q. Did this fact have any effect upon your decision to go into new ventures only as a corporation after 1938?

A. Will you please state the question again?

The Court: Read the question, please.

(The question was read.)

The Witness: Well, as I stated previously, I refused at any time to sign a lease that held me for any long length of time on a corner that—something that might break me if the place failed. I wouldn't take the personal responsibility.

(Testimony of Harry B. Carpenter.)

By Mr. Webster:

Q. Mr. Carpenter, do you know Mr. M. A. McDonnell? A. Quite well.

Q. How long have you known him?

A. Forty years.

Q. Where did your acquaintance first occur?

A. Kansas City, Missouri. At that time Mr. McDonnell had a place, a restaurant, on one street, and I had one on the other, around the corner, and our kitchens were next door to each other. We used to meet in the alley and talk the restaurant business over, 40 years ago.

Q. Do you know when Mr. McDonnell came to California?

A. He came in 1916, in the fall; I came in the spring.

Q. Have you been in contact with each other after you came to California? A. Yes.

Q. Are you familiar with his manner of doing business? A. I am.

Q. Do you know whether he met the same type of situation which you have previously described with respect to this cancellation clause?

A. I personally know that he has never signed a lease since coming to California that he couldn't cancel upon certain days' notice, certain length of time.

Q. By "personally" you mean what?

A. We discussed the matter many, many times, and it was upon his advice that I have always operated on the kick-off clause, or a corporation.

(Testimony of Harry B. Carpenter.)

Q. Mr. Carpenter, in view of your long experience in the restaurant business, would you state to the Court your opinion as to the relative safety or relative hazards [130] associated with the restaurant business?

A. Well, I have belonged to the National Restaurant Association since its organization about 1917. I have attended many of the conventions, and it has been discussed by the leading restaurant men in the United States as considering it the most hazardous line of business there is.

Q. Have you ever had any interest in the past in restaurants which have failed?

A. Yes, I have.

Q. Mr. Carpenter, you have stated that you have had a separate business unit since 1938, and that business unit was a corporation for each location.

A. That is right.

Q. Can you state why that was so?

A. Why the separate corporations were formed?

Q. For each location.

A. That was to prevent, in case of failure, of one large investment, of the tearing down of all the places and tearing them all down.

Q. Turning now to the particular corporation with which we are concerned, Wilshire and Western Sandwiches, Inc., do you recollect when this deal was first discussed?

A. Very early in 1941.

Q. Mr. Carpenter, you were in court yesterday, were you not, when testimony was received from

(Testimony of Harry B. Carpenter.)

Mr. Simon to the [131] effect that the original thought was to open a combination drive-in and bar on the southwest corner of Wilshire and Western Avenue, and that this deal fell through and that Mr. Simon had negotiated a lease on the northwest corner of Wilshire and Western, which lease was assigned to Wilshire and Western Sandwiches, Inc. Are those facts correct?

A. Those are facts as he stated yesterday. I had been located on this other property for a good number of years. I approached the landlord and asked him if he would advance a portion of the money if we formed a corporation in connection with Mr. McDonnell, Mr. Simon, and Mr. Lyman, and put in a larger place occupying the entire block.

I occupied half of it at the time. He was very receptive to the idea and we entered into negotiations for lease. I went East to get a very well known restaurant man who was working as the manager of a large restaurant, and attempted to persuade him to come out and take charge of this place and run it for me.

Q. Pardon me, Mr. Carpenter. Do you know approximately when it was you made this trip?

A. That was in 1940, in the fall of 1940. I also attended the National Restaurant Convention on the same trip. He and his wife were loath to leave Chicago, so I came back and told Mr. Simon, Mr. McDonnell, that as far as I was concerned the deal was off. It was too large a restaurant for [132]

(Testimony of Harry B. Carpenter.)

me to attempt to run, in connection with my other places, and I preferred to pass it up.

In the meantime Mr. Simon was negotiating for a smaller unit, for just a straight drive-in, on the northwest corner of Wilshire and Western.

Q. In whose name was the proposed large place on the southwest corner to be in, that is, under what name was that place proposed to be operated?

A. Carpenter.

Q. At the time that Mr. Simon was negotiating this lease on the northwest corner, under what name was the proposed location to be operated?

A. Those negotiations were started while I was East. I don't know. I think that he intended to operate that in addition to the one that I might put in on the south corner. But the lease was drawn up and it was drawn up in Mr. Simon's name, with the understanding that he could transfer it to a corporation and it wouldn't be under any obligation to pay the rent after the corporation received the lease. He assigned it to the corporation.

Q. When did you first speak of forming Wilshire and Western Sandwiches, Inc.?

A. That was in connection with the other place, originally. I insisted, by the way, after I came back and we all agreed to go ahead and form the corporation and operate the [133] smaller unit, that as long as I had been on this corner for approximately 11 years, that I still be allowed to operate under my trade name. I felt it was a very well

(Testimony of Harry B. Carpenter.)

known one and we had a good reputation in the neighborhood.

Q. Was there any understanding about that time as to who would be in active supervision over that location that the taxpayer now occupies?

A. After making this assertion, it was agreed by all I could operate the place.

Q. Now, there was no drive-in on the property in early 1941, was there?

A. On the present property?

Q. On the present property. A. No.

Q. Was there any understanding as to who would supervise the construction of that drive-in?

A. Yes, the operator was to do that, myself.

Q. That is, you? A. Yes.

Q. Do you hold any office in Wilshire and Western Sandwiches? A. Yes.

Q. What office? A. President.

Q. Mr. Carpenter, do you recall any discussions with [134] respect to the capital structure of Wilshire and Western Sandwiches in early 1941?

A. Yes.

Q. What was the nature of those discussions?

A. Well, the other boys seemed to think that we could erect and equip the drive-in for a maximum of \$30,000.00. I told them that I had opened between 40 and 50 restaurants and drive-ins, and that I had always found that the cost exceeded the estimate. I felt that we should plan on at least \$50,000.00.

Q. Was there any discussion with respect to the

(Testimony of Harry B. Carpenter.)

amount of money which was to be put in by—
Strike that question.

With whom were these discussions?

A. Mr. McDonnell, Mr. Simon, and Mr. Lyman and myself.

Q. Was there any discussion at this time, which was early 1941, with respect to the amount of money which would be paid in by the four of you?

A. Yes. We agreed to pay in the \$30,000.00, but we would split it up on a fifty-fifty basis in regard to what we called an investment, always we considered capital stock. We always took notes for what we called a loan. We had done this previously.

Q. You actually had a discussion on that subject at that time? A. Yes. [135]

Q. Did the others agree on this method of—

A. Yes.

Q. Mr. Carpenter, the corporation is authorized, under its articles of incorporation, to issue a total of \$75,000.00 worth of stock, 7,500 shares at \$10 per share at par? A. I think that is correct.

Q. Can you explain how that amount was arrived at?

A. Yes. I went up to my attorney's office.

Q. Pardon me. Your attorney?

A. Mr. Robert Odell—and asked him to draw corporate papers and form a corporation called Wilshire and Western Sandwiches, Inc.

I don't remember his exact words, but they virtually were to the effect, "How much do you want to incorporate for?" I named some sum, approxi-

(Testimony of Harry B. Carpenter.)

mately what I thought the cost might be—I don't remember — somewhere around \$35,000.00 or \$40,000.00.

He said, "It doesn't cost any more to form a corporation with capital stock of \$75,000.00, because I am going to form one that has broad powers. You can buy and sell real estate. You don't know what might come up in the future, what you might want to do. It won't do any harm."

I said, "You draw it up."

Q. Mr. Carpenter, what was your own personal feeling with respect to these discussions as to a part-stock, part-loan [136] basis?

A. What was my personal opinion?

Q. Yes. Were you in favor of it or against it?

A. Oh, yes, I was very much in favor of it.

Q. Can you state why you were in favor of it?

A. Well, we knew that if we took the whole thing in stock, the ever-present possibility of a failure entered into the picture, and we would lose probably the entire investment because you can't ever realize 100 per cent on a failure. So we thought that if we took 50 per cent in stock and 50 per cent in notes, as we had done in the past, that we would at least come in with the creditors in case of failure and realize part of our investment.

Q. Mr. Carpenter, it has been stipulated, that is, counsel for the Government and counsel for the Petitioner have agreed, that you took part in other corporations in which there was a part-stock,

(Testimony of Harry B. Carpenter.)

part-note setup. These corporations are as follows: F. & L. B. Corporation, which commenced business in October of 1941; Carsim, Inc., which commenced business in June of 1939; Simon's Florat, Inc., which commenced business in November of 1941; Simon's Five Points, Inc., which commenced business in November of 1941; and Sunset Sandwiches, Inc., which commenced business in January of 1941.

With respect to those corporations which I have just [137] named, did you receive stock certificates from those corporations? A. I did.

Q. Did you receive notes from those corporations? A. I did.

Q. Did you consider yourself both a stockholder and a lender to those corporations?

A. Yes, sir.

Q. Can you state why you entered into a part-loan, part-stock arrangement with respect to those other corporations?

A. Well, in each instance I was a minority stockholder and I had no say as to what dividends might be paid. But as a noteholder I could demand repayment of the note on the day it matured or soon thereafter.

Q. Were any of the considerations which you thought of in the Wilshire and Western deal present in these other deals?

A. They were all very similar.

Q. Had you discussed these points with the other gentlemen whom you entered into the trans-

(Testimony of Harry B. Carpenter.)

actions with? A. Many, many times.

Q. Were you in agreement with them?

A. Yes.

Q. I would like to turn for a moment to the subject of your estimates as to the cost of erecting the drive-in at Wilshire and Western. When the deal was first discussed, [138] what is your recollection of your estimate at that time?

A. My estimate was that it would be closer to \$35,000 than \$30,000.

Q. Upon what basis did you make this estimate?

A. Because I had just supervised the erection and opening and operation of Sunset Sandwiches, which, if I remember correctly, we opened in January of this same year, 1941. That place cost \$34,000, by the way.

Q. Pardon me?

A. That place finished up with a total of \$34,000, I think, even to the dollar.

Q. Had you formed an estimate as to the relative cost of the building and of the equipment?

A. It was the usual procedure to estimate 50 per cent, and ordinarily it didn't vary very far from that.

Q. By 50 per cent you mean—

A. Half building and half equipment and fixtures.

Q. It has been stipulated, Mr. Carpenter, that in June of 1941 you received four bids from four different contractors to erect the building, and that

(Testimony of Harry B. Carpenter.)

one of these bids was from Frank A. Woodyard in the amount of \$18,222. A. That is correct.

Q. Did this bid fit in with your idea of what the approximate cost would be?

A. It wasn't very far off. [139]

Q. It has also been stipulated that in July, on July 10th of 1941, a construction contract was entered into between the corporation and Mr. Woodyard for \$22,651, or approximately \$4,400 more than the original bid. Did this have any effect upon your estimate at that time, of what the cost of the drive-in would be?

A. I felt it would increase it the amount of the increase in the bid, but I didn't think that it would cause the fixtures to run any higher. There were some certain changes the architect made in the building plans. I think one of them was extending the size of the canopy.

Q. As time went on, Mr. Carpenter, did your estimate prove to be accurate or inaccurate?

A. It proved to be inaccurate.

Q. When did you commence discovering this inaccuracy?

A. The first intimation I had that we might run into considerable more money was when the City Building Department made us—increased the strength of the canopy I just spoke about, because of the fact we had enlarged it, made it cover a larger area of the car; and several other changes from the Building Department.

Q. At approximately what date did that occur?

(Testimony of Harry B. Carpenter.)

A. Oh, it was either in August or early September.

Q. It has been stipulated that on July 17th of 1941, a permit was granted from the California Corporation [140] Commissioner to issue shares of stock of Wilshire and Western Sandwiches. Do you know whether any shares of Wilshire and Western Sandwiches were ever issued?

A. Yes.

Q. When were they issued?

A. They were issued sometime after the place opened in November.

Q. Can you account for the delay between the date of the permit and the date when the stock certificates were issued?

A. Yes, because we couldn't determine the amount to be issued in stock or the amount to be issued in notes until we had a better idea of the complete cost of the opening of the unit.

Q. Mr. Carpenter, it has been stipulated that in May and June of 1941 you, Mr. Simon, Mr. Lyman, and Mr. McDonnell contributed a total of \$10,000 to the corporation, that is, paid in. Also, it has been stipulated that in August and September these same four individuals contributed \$15,000 or paid in \$15,000, and that in October you, Mr. Simon, and Mr. Lyman paid in \$10,000, and that in November the four of you paid in \$20,000. Was anyone responsible for the fact that these payments were spread out the way they were?

A. Yes, I was. [141]

(Testimony of Harry B. Carpenter.)

Q. Can you describe to the Court the circumstances surrounding these payments?

A. Well, the bank account was in my name and I was supervising the building of the building and the ordering of the fixtures. I paid all the bills. As the bank account began to get low, I would call for more money and put in my share along with the rest of them.

Q. You say you would call for money. Physically, how would you go about doing that?

A. I would call them up and in some instances I probably went down; in fact, I know I made many trips to Mr. Simon's office.

Q. When did you arrive at the conclusion that you had received a sufficient amount of money to cover the cost?

A. After the place opened up, shortly after the 5th of November.

Q. By the way, Mr. Carpenter, you stated that the bank account was in your name. Could you tell why it was in your name?

A. Somebody had to—always the man that was to operate the unit had the bank account in his name. I say it was in my name; it was in the name of Wilshire and Western, and I was authorized to sign the checks.

Q. I see. You say that shortly after the drive-in opened in November you felt that you had received a sufficient [142] amount of money?

A. Well, I called the boys up a week, such a matter, after I opened up and asked them to come

(Testimony of Harry B. Carpenter.)

out and see the place. They hadn't been near it. So they all came out, and while they were there I discussed the finances. I told them that we had—we were going to spend a lot more money than we had ever anticipated spending, so I thought we should decide on the amount of stock to be issued and the amount in notes, and we discussed it informally at the counter of the drive-in.

The amount of money I had spent didn't seem to disturb them, so I got in touch with Mr. Odell and told him we had arranged to have a meeting the following day—I don't remember the exact date—in Mr. Simon's office, and told him exactly what we had agreed on. He typed out the minutes and accompanied me the following day to Mr. Simon's office where we had the meeting.

Q. You say you agreed as to the amount of money you required. Do you know how much money was paid in? A. At that time?

Q. At that time.

A. I don't remember exactly how much; I know Mr. McDonnell was a little lax with his last payment. I had to phone his office several times trying to get in touch with him and chase him down. [143]

Q. Counting that last payment as committed to but actually not paid, how much money by the time you had held your meeting—

A. \$55,000.

Q. \$55,000? A. That is right.

Q. And at the time of the informal meeting at the drive-in, about which you have testified—

(Testimony of Harry B. Carpenter.)

A. Yes.

Q. —was there an understanding as to the—

Mr. Maiden: Your Honor, I object to his leading the witness. Let the witness tell what occurred at these conferences.

The Court: Don't lead your witness. You have heard what I said about leading testimony. I mean it.

Eventually I have to evaluate the evidence, coming to my conclusion; regardless of whether there is an objection on account of its being leading, the fact you lead the witness logically makes the answer partly yours, rather than the witness'. I discount it to that extent. Now, for your own benefit—

The Witness: I know exactly—

The Court: I am not talking to you, Mr. Witness.

For your own good, don't lead the witness. That applies just as equally to one side as the other.

By Mr. Webster:

Q. Mr. Carpenter, I show you Petitioner's Exhibit 12, which is a written consent and waiver notice of a directors' meeting, and attached to that are the minutes of a meeting of the board of directors of Wilshire and Western Sandwiches, Inc.

A. What date?

Q. Consisting of five pages. The date is November 13, 1941. I ask you whether the signature on the written consent and waiver of notice, appearing on the second line, is yours? A. Yes.

(Testimony of Harry B. Carpenter.)

Q. Turning to the last page of the minutes, over the line for signature, calling for the signature of the president, I ask whose signature that is.

A. That is mine.

Q. Have you even seen these minutes?

A. Yes, they look very familiar.

Q. When did you see them?

A. I saw them at the meeting when Mr. Odell brought them up to Mr. Simon's office.

Q. Did you sign them at that meeting?

A. Yes.

Q. Did you read them over at that meeting?

A. Mr. Odell read them to all of us. Mr. Odell being a man who very—oh, I don't know how to explain it—he [145] insisted that everything be regular, that the meeting be called to order in the proper way and that the vote be taken on the various matters of the minutes, or what not. I don't think there was ever a meeting held that amounted to anything—we might meet informally and discuss something—there was never a meeting held where there were any minutes drawn up in either this or any other corporation that Mr. Odell had anything to do with that he didn't insist on being present.

Q. Were you present at the time the other individuals signed those minutes?

A. Yes.

Q. You stated that Mr. Odell read the minutes to you?

A. That is right.

Q. Was there any discussion following the reading of those minutes?

(Testimony of Harry B. Carpenter.)

A. I can't recall any now, any more than they were approved and signed and agreed to. I might add, if I could, that when the informal meeting took place at Wilshire and Western at the counter, that I told them I was sure it would go as high as \$55,000 and might run over a thousand or two, but I felt we were going to have a successful operation and I could pay out the balance out of the profits as they came in, and we wouldn't have to advance any more money.

Q. Did Mr. Odell call for a vote of the people who were present? [146] A. Yes.

Q. Did he call for a vote on each resolution?

A. Yes.

Q. Was this customary? A. Yes.

Q. It was Mr. Odell's practice?

A. With Mr. Odell, yes.

Q. How long have you had Mr. Odell as an attorney?

A. Thirty years, or thirty-one; I met him very shortly after I came to California.

Q. It has been testified that by the end of November of 1941 a total of \$55,000 had been paid in.

A. That is correct.

Q. Did this turn out to be sufficient?

A. No.

Q. Then you describe what circumstances later took place.

A. Along towards the first of the year, when the miscellaneous bills came in, some of them I had forgotten about and others were much larger than

(Testimony of Harry B. Carpenter.)

I had anticipated, and I had to call the boys up and apologize to them and say, "Fellows, we are going to have to have another \$10,000. I would like to borrow that without issuing any notes, and pay it back probably before the end of the year."

One of the reasons for the increase was the fact that [147] I had been kicked off the corner across the street, or notified on the 60 or 90 days' notice, whichever it was, and I had to move from over there on the first day of November. As a matter of fact, I was supposed to have my building cleared off by the 1st of November. They gave me an extra week to get the building off, so I operated the business working day and night, trying to get Wilshire and Western open by the 1st of November. I missed it five days. I continued to operate the old place until we operated the new, and then got busy and tore down and left the lot in first-class condition at the old location.

Q. Did the other three whom you contacted send in any money? A. Yes.

Q. What were the amounts?

A. I put in thirty-three hundred thirty-three dollars and some cents. McDonnell did likewise, and Simon and Lyman between the two of them put in an equal amount, making the \$10,000.

Q. Do you recall approximately when that money was paid in?

A. It was after the first of the year, probably after the first of February.

Q. Did you issue any notes?

(Testimony of Harry B. Carpenter.)

A. No, not for that \$10,000. [148]

Q. Was any interest paid? A. No.

Q. Do you know whether this \$10,000, of which you speak, was repaid?

A. Yes, it was repaid and it was repaid before the end of the year, if I remember correctly.

Q. Mr. Carpenter, I show you Check No. 793, Check No. 794, and Check No. 795, all bearing the imprint in the lower right-hand corner, "Wilshire and Western Sandwiches, Inc." They are made out to Mike Lyman, M. A. McDonnell, and H. B. Carpenter, and they bear in the upper right-hand corner a description "Note Account." The date of all three of them is September 7, 1942. I ask you if you recollect these checks. A. Yes.

Q. Is that your signature (indicating)?

A. In every instance.

Q. What was your understanding with respect to these checks? ;

A. That they were the repayment of that \$10,000 that I called for and received early in '42.

Q. Do you recall making out a similar check for Mr. Simon? A. I do.

Mr. Webster: I offer these as Petitioner's exhibits [149] next in order.

The Clerk: One exhibit or three separate exhibits? Mr. Webster: One exhibit.

The Clerk: Exhibit 16 has been offered, your Honor.

The Court: Three checks identified by the witness will be admitted in evidence as Exhibit 16 for the Petitioner.

(Testimony of Harry B. Carpenter.)

(The checks above-referred to were received in evidence and marked Petitioner's Exhibit No. 16.)

Mr. Shearer: If your Honor please, Petitioner's 15 is a similar check. It might avoid confusion if they were all added to Petitioner's 15, if that were possible.

The Court: I see no reason to do that.

Mr. Shearer: All right.

The Clerk: The checks have been marked No. 16 in evidence.

By Mr. Webster:

Q. Mr. Carpenter, what was your intent with respect to the \$3,333.33 which was paid in by you in February of 1942?

A. The intent? The intent was to loan the money to the corporation so the corporation could pay the unpaid bills.

Q. It has been stipulated that outside of this last amount which I have just spoken of, that you advanced a total of \$18,333.33, and it has also been stipulated that these advances took place between June and November of 1941. Can you state what your intent was at the time of each advance? [150]

A. My intent at the time of each advance was that the total amount should go into the treasury of the corporation and that in due time I would be issued stock and a note for approximately 50 per cent of each payment.

Q. Mr. Carpenter, I show you a rectangular black book and ask you if you can identify it.

(Testimony of Harry B. Carpenter.)

A. Yes, that is the stock book of Wilshire and Western Sandwiches, Inc.

Q. Have you ever seen it before?

A. Many times.

Q. Where did you see it?

A. In Mr. Odell's office.

Q. Did you ever place your signature in the book or on any pages of the book?

A. Yes, I signed a receipt for any stock and signed each stock certificate before it was issued.

Q. Mr. Carpenter, I call your attention to a stub bearing the imprint "Certificate No. 3," and attached to this stub is a certificate which is numbered "No. 3." Both the stub and the certificate indicate they were issued to William H. Simon.

A. That is correct.

Q. Do you recall signing the certificate?

A. Yes.

Q. Can you explain why this certificate is in this [151] book?

A. Yes. Simon told me that he wanted to give Joe Lerdemer, his general manager, an interest in his investment of this corporation. In authorizing Mr. Odell to issue these shares of stock I forgot it.

Q. When did Mr. Simon tell you about wanting to make a gift?

A. It was along during 1941; I don't remember.

Q. Can you place it with respect to the fall or the summer or the spring?

A. I would say either late spring or early summer. And these shares were issued and mailed or

(Testimony of Harry B. Carpenter.)

delivered, I guess—no. I don't remember whether I took them up or Mr. Odell took them up. Anyway, he asked me to have the shares re-issued, giving Mr. Lerdemer a percentage. I think it was ten percent of both Mr. Simon's and Mr. Lyman's investment in this corporation, of their stock.

Q. Had Mr. Lyman spoken to you about making—

A. No, Mr. Lyman talked very little in regard to the affair. After this came up they both instructed me to have Mr. Odell re-issue these shares decreasing their holdings ten percent, in each instance, and giving the ten percent to Joe Lerdemer.

Mr. Webster: I offer this stock book in evidence as Petitioner's exhibit next in order. [152]

The Court: The last number was sixteen. The stock book is admitted in evidence as Petitioner's Exhibit 17.

(The stock book above-referred to was received in evidence and marked Petitioner's Exhibit No. 17.)

By Mr. Webster:

Q. Mr. Carpenter, the stock book which you were just looking at shows that one thousand shares were issued to you. Did you receive those shares?

A. Yes.

Q. When did you receive them?

A. Oh, a short time after the—after the meeting we held in Simon's office, possibly two weeks, possibly a month; I don't remember.

Q. Mr. Carpenter, I show you a letter on the

(Testimony of Harry B. Carpenter.)
stationery of Tanner, Odell & Taft, dated December 5, 1941, and addressed to you, and ask whether you have ever seen this letter before?

A. Yes, the note and the stock came along with this letter to my office.

Q. Are you familiar with Robert Odell's signature? A. Yes, indeed.

Q. Is this his signature (indicating)?

A. It is. [153]

Q. You say this was the letter which transmitted your stock certificate and note?

A. And note; they came together.

Q. Can you recall when you received this letter?

A. Well, it is dated December 5th. I certainly received it very shortly thereafter.

Q. There was nothing unusual about the date of the letter with respect to the date of receipt of it?

A. No.

Mr. Webster: Your Honor, I offer this letter in evidence as Petitioner's exhibit next in order.

The Court: Is there any objection?

Mr. Maiden: No objection, your Honor.

The Court: The letter as identified by the witness is received in evidence as Petitioner's Exhibit No. 18.

(The letter above-referred to was received in evidence and marked Petitioner's Exhibit No. 18.)

By Mr. Webster:

Q. I show you three documents and ask you to identify them.

(Testimony of Harry B. Carpenter.)

A. These are all notes of the corporation, signed by me.

Q. One of them is made out to M. A. McDonnell in the amount of \$8,333.33. This is your signature (indicating)?

A. Yes, it is.

Q. Another is made out to Mike Lyman in the amount of [154] \$4,166.66, and is this your signature on it (indicating)?

A. That is.

Q. And a third is made out to Harry B. Carpenter in the amount of \$8,333.34. Is this your signature on it (indicating)?

A. It is.

Q. These notes are dated November 13, 1941. Do you recollect when you signed these notes?

A. Well, I would say I signed them on that date, November 13th, but I am not absolutely positive now. That would be awfully hard to say. I don't remember where I signed them, either, whether it was at this meeting or over at Mr. Odell's office.

Q. If it wasn't on November 13th, was it—you would say it was close to that date?

A. Yes.

The Court: You are leading your witness. The witness said he didn't know. Let it go at that. Don't try to get him to say something different.

Mr. Webster: I offer these three notes in evidence.

The Court: Offer them one at a time.

The Clerk: No. 19.

The Court: Petitioner's Exhibit 19. What is Exhibit 19, the size of the note?

(Testimony of Harry B. Carpenter.)

The Clerk: \$8,333.34, dated November 13, 1941.

The Court: Admitted in evidence.

(The note above-referred to was received in evidence and marked Petitioner's Exhibit No. 19.)

The Clerk: Note dated November 13, 1941, in the amount of \$4,166.16, is No. 20.

The Court: Admitted in evidence.

(The note above-referred to was received in evidence and marked Petitioner's Exhibit No. 20.)

The Clerk: No. 21, dated November 13, 1941, in the amount of \$8,333.33.

The Court: Admitted in evidence.

(The note above-referred to was received in evidence and marked Petitioner's Exhibit No. 21.)

The Witness: I might add to that, that the reason I don't think they were signed or even made out at this meeting was because my son's signature is on there with me, and he wasn't present at the meeting.

By Mr. Webster:

Q. Mr. Carpenter, what was your intent with respect to the \$8,333.34, represented by the note?

A. I was to loan it to Wilshire and Western Sandwiches, Inc., and receive interest on it, and to be paid in full if we ever got enough money to pay it with, along with the others.

Q. Have you ever thought of going to a bank to borrow the money? [156]

(Testimony of Harry B. Carpenter.)

A. Yes. We discussed going to a bank to borrow money. And we all agreed that we would rather receive the interest on the money at a pretty good rate of interest than to pass it along.

Q. Mr. Carpenter, it has been stipulated that on April 21, 1943, a check was issued to you in the amount of \$3,333.34, with an explanation in the voucher portion of the check which read, "Payment on note." Do you recall receiving this check?

A. Yes.

Q. What was your understanding?

A. That that was a payment on the note.

Q. It has been stipulated that on May 23, 1944, a check was issued by the corporation to you in the amount of \$3,333.33, and that the explanation in the voucher portion of the check reads, "Note Account." Do you recall receiving this check?

A. Yes.

Q. At about the time of the check?

A. Correct.

Q. And what was your understanding?

A. It was repayment of the note.

Q. On May 23, 1945, it has been stipulated that a check was issued by the corporation in the amount of \$1,666.66, bearing an explanation in the voucher portion of [157] the check, "Balance on note." Do you recall receiving that check?

A. Yes, I do.

Q. What was your understanding at the time of receipt?

A. That the notes had been paid in full.

(Testimony of Harry B. Carpenter.)

Q. Mr. Carpenter, I show you Checks Nos. 2045, 2047, and 2048, bearing the imprint in the lower right-hand corner, "Wilshire and Western Sandwiches, Inc." Two of them have an explanation in the voucher portion, "Interest to November 30, inclusive." The third one has an explanation, "Interest to November 1, inclusive." Do you recall seeing these checks? A. Yes, I do.

Q. Is that your signature on the checks (indicating)? A. Yes; every one.

Q. Do you recollect what the purpose of these checks was?

A. Yes, it was to pay the interest to the date on the—the day before the date on the check. This is just an error, "November 1"; it should read "30th".

Q. You are speaking about Check No. 2048?

A. That is right.

Mr. Webster: I offer Check No. 2045 in evidence as Petitioner's next in order.

The Court: Admitted in evidence as Petitioner's Exhibit 22. [158]

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 22.)

Mr. Webster: Check No. 2047.

The Clerk: 23.

The Court: Admitted in evidence as Petitioner's Exhibit 23.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 23.)

(Testimony of Harry B. Carpenter.)

Mr. Webster: Check No. 2048.

The Court: Admitted as No. 24 by the Petitioner.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 24.)

By Mr. Webster:

Q. Mr. Carpenter, were there any previous payments of interest prior to the payments represented by this check? A. I think not.

Q. Do you happen to know why?

A. I have to say carelessness, I imagine.

Q. Carelessness on whose part, would you say?

A. That is self-evident.

Q. Mr. Carpenter, I show you next Nos. 4134, 4141, and 4146 of the Wilshire and Western Sandwich, Inc., all dated March 23, 1945, and they all have an explanation, "Interest on note to March 24." I ask you if you recall seeing these checks.

A. Yes.

Q. Is that your signature (indicating)?

A. It is.

Q. What was your understanding at the time of making out those checks?

A. This was the interest on the notes to this date; probably in full. I don't remember.

Q. By the way, with respect to this payment, was a check made out to Mr. Simon?

A. Yes.

Q. At this time?

A. I am sure. Let me see them. Well, if there

(Testimony of Harry B. Carpenter.)

wasn't, it was certainly a gross error on the book-keeper's part.

Q. A check is in evidence which was made out to Mr. Simon as of this date. Do you recall having made that out?

A. Well, I don't recall it individually, but I would assume that I did. Anyway, those are my signatures.

Q. They are? A. Yes.

Mr. Webster: We offer Check No. 4134.

The Court: Admitted in evidence as Petitioner's Exhibit No. 25.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 25.)

Mr. Webster: Check No. 4141. [160]

The Court: Admitted as No. 26 for the Petitioner.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 26.)

Mr. Webster: Check No. 4146.

The Court: Admitted as Petitioner's Exhibit No. 27.

(The check above-referred to was received in evidence and marked Petitioner's Exhibit No. 27.)

By Mr. Webster:

Q. Mr. Carpenter, did you know anything about—what do you know about the books of account at Wilshire and Western Sandwiches?

(Testimony of Harry B. Carpenter.)

A. I don't know anything.

Q. Who was in charge of the books?

A. At the present time?

Q. Yes.

A. Mr. Tompkins. That might be a little confusing to me. Do you mean the bookkeeper that I employ in my office or the accountant that transfers the accounts in my office onto the set of books of the corporation?

Q. I mean the latter.

A. That is Mr. Tompkins.

Q. Has he always been your accountant?

A. No.

Q. Who was your accountant previously?

A. In the first place it was Colonel Whittaker. The [161] second was Mr. E. J. Aye. When Mr. Aye retired, Mr. Tompkins took the account over personally.

Q. How long was Mr. Whittaker retained by you?

A. After the corporation—

Q. Yes. A. I would say—

Q. I mean as to how long it was that Mr. Whittaker was retained by the corporation.

A. I don't think he ever did any work after preparing the income tax for the year '41. He might possibly have worked another month; might have entered one more month's statements.

Q. What was the reason for his leaving?

A. Dissatisfaction; dissatisfied with him.

Q. Pardon me?

A. I was dissatisfied with his services.

(Testimony of Harry B. Carpenter.)

Q. Whom did you then employ?

A. Mr. Aye.

Q. Mr. Carpenter, there has been admitted in evidence Exhibit 8-H, a copy of the 1941 tax return of the corporation. Do you recall signing that return? A. I do.

Q. Did you read it over prior to signing it?

A. No. Mr. Whittaker expressed it correctly, exactly, when he says, "Where do I sign and how much do I pay?" [162]

The Court: We will be recessed at this time for ten minutes.

(Short recess taken.)

By Mr. Webster:

Q. Mr. Carpenter, you have just testified that you signed the 1941 tax return of the corporation, which was Exhibit 8-H. What were the circumstances surrounding your signature or the signing of that return?

A. I think I answered that.

Q. I will withdraw that question.

Do you recollect signing any other tax return with respect to the calendar year 1941?

A. Yes, I think there was an amended return. I know there was one prepared by Mr. Aye.

Q. Do you recollect what the circumstances were surrounding the signing of that return?

A. The only thing that I remember is that we showed that we overpaid our tax in '41, and we asked for a refund; that is all I can remember about it.

(Testimony of Harry B. Carpenter.)

Q. Did Mr. Aye bring that return to your office?

A. Yes.

Q. When?

A. I think very shortly after he took charge of my books.

Q. When was that? [163]

A. That was in April, approximately April of '42.

Q. Of 1942? A. Yes.

Q. Did he leave the return with you?

A. No, he took it with him and left me a copy. And Colonel Whittaker left me a copy of the original when he signed it. But I don't know where they are.

Q. Mr. Carpenter, did you ever enter into any agreement with a creditor of Wilshire and Western Sandwiches under which you subordinated your rights under your note to the rights of any creditor?

A. No, sir, positively not.

Mr. Webster: That is all, your Honor.

The Court: Cross-examine.

Cross Examination

By Mr. Maiden:

Q. Mr. Carpenter, at the time of the organization of this corporation it was the intention of you and your associates to advance to the corporation such money as it needed to build its building and equip it and open it for business, is that correct?

A. That is correct.

Q. You considered that the whole amount of

(Testimony of Harry B. Carpenter.)

the money you advanced was an investment in the business?

A. I considered 50 per cent of it as an investment in [164] stock, and the other 50 per cent as notes, as a debt on the corporation.

Q. Why weren't you willing to invest your share of the total cost necessary for the business to begin operations?

A. Why wasn't I—what was the word you used there?

Q. Why weren't you willing—

A. "Willing"—

Q. —to invest the entire amount of your portion of the total amount of money necessary for the corporation to open its doors for business?

A. Principally because of the hazardous undertaking and the fact that if the business failed I would come in equally with the other creditors on 50 per cent of the money I had put into the organization.

Q. Well, since it was so hazardous, why were you willing to invest any money in the business?

A. I either had to do business or starve to death.

Q. Was it in your mind to become a creditor of this corporation so that if the corporation failed you could come in with the other creditors and keep them out of some of the money that the corporation owed them?

A. I think I stated I would share equally with them.

(Testimony of Harry B. Carpenter.)

Q. Well, in sharing equally with the creditors of your corporation, you would in effect be taking that much money away from the satisfaction of their debts, wouldn't you? [165]

A. I would alter that by saying I wouldn't take near as much away from them as they would take away from me, in the event of failure.

Q. But the debts would have been created upon the good faith and credit of the corporation, of which you and these gentlemen were in control?

A. I think my debt was created the same way.

Q. Wouldn't you consider the necessary debts in the operation of this business a moral obligation on you?

A. I will answer that by saying that I have always paid every debt to date, since I have been in business, and don't owe anybody a dollar.

Q. Isn't it a fact, Mr. Carpenter, that you and these gentlemen conceived this plan or arrangement in order that you could receive a return out of your current earnings of a large portion of your capital without having to pay any tax on it, and at the same time to allow the corporation to make payments to you of interest out of current earnings which would otherwise be dividends, and get a tax benefit from it?

A. Mr. Maiden, you are too fast for me. I can't follow you.

Mr. Maiden: Read the question.

The Court: Read the question.

(The question was read.) [166]

(Testimony of Harry B. Carpenter.)

The Witness: I will answer that as no, and verify it by stating we would have taken the notes and had the same setup if the tax proposition hadn't entered into it. We would have protected ourselves in the same manner.

By Mr. Maiden:

Q. Were you aware of the tax benefit this arrangement would bring to you and the corporation?

A. I was.

Q. Do you mean to tell this Court that did not influence in the least the formation of this arrangement?

A. I said that the same formula would have been carried out if the tax feature hadn't been there.

Q. So that you deny that you were in the least motivated in the formation of this arrangement by tax benefit? A. I do.

Q. You were aware of the fact, weren't you, Mr. Carpenter, that in 1941 the tax rates had begun to increase considerably?

A. I thought the big increase came in the fall of '41; I don't remember.

Q. Being a businessman, you are always conscious and have always been conscious of the important part of federal taxation?

A. That is right.

Q. Now, what difference actually did it make to you, [167] so far as getting your money back—forgetting the tax angle—whether you held this entire amount of money as stock or part of it in notes?

(Testimony of Harry B. Carpenter.)

A. What difference did it make in getting the money back?

Q. Yes.

A. It would have made a great difference had the place not been successful.

Q. How would it have been a great benefit if it hadn't been successful?

A. Well, we started out immediately by depreciating the building and equipment, and as the place went along, even if it had only made a few dollars a month, instead of making more than that, we would have still had accumulated enough money to have paid off the notes where we probably never could have paid any dividends on stock.

Q. How do you know you would have accumulated enough money to have paid off the notes?

A. I don't know it, of course, any more than I knew about any of the businesses I had started; I have had some that failed and some that didn't.

Q. This corporation had to make money before it could set up any reserve for depreciation.

A. It had to make at least that much.

Q. I want to ask you, as a fact, Mr. Carpenter, did [168] this corporation each year set aside a cash reserve for depreciation?

A. It showed on the book; there wasn't a separate bank account made for it.

Q. Was cash actually earmarked and set aside in the bank account for depreciation? You just look at me, Mr. Carpenter.

A. I am answering your questions just as truth-

(Testimony of Harry B. Carpenter.)

fully as I can. I say there was never but one bank account. The books each month showed the depreciation on the fixtures and the building, and I knew at the end of each month where I stood.

Q. I am not talking about your books, I am talking about the bank account.

A. There was never but one bank account, I said.

Q. This bank account was used to pay all current expenses of the business?

A. That is right.

Q. Regardless of whether or not any was left for depreciation, isn't that true?

A. I will have to have that read.

Q. You need this money in your bank account to pay the current operating expenses of your business, and you used all of that cash, if necessary, whether or not you left any for depreciation reserve? [169]

A. As long as there was any money in the bank, we would pay our bills.

Q. Now, Mr. Carpenter, you knew of course that this note that you received from the corporation was only as good as the earning capacity of that corporation?

Mr. Shearer: Just a moment. I object to that as calling not only for a conclusion but the question obviously is incorrect accountingwise.

Mr. Maiden: Your Honor, I don't care a thing on earth about accounting with this question.

The Court: Read the question.

(Testimony of Harry B. Carpenter.)

(The question was read.)

The Court: The objection is overruled. Exception allowed to the Petitioner.

The Witness: It was only as good as any money that might be in the bank to cover it, plus the protection we would have if the place failed, went into bankruptcy.

By Mr. Maiden:

Q. You say that if the corporation failed you wouldn't be entitled to take whatever cash reserve they may have had for depreciation, you would have had to share it with other creditors?

A. That is correct.

Q. You wouldn't have hesitated pursuing your claim in case of failure, to the detriment of other creditors, isn't [170] that right?

A. That is correct.

Q. Even though some of your creditors had to go without being paid in full, that wouldn't make any difference to you?

A. I don't see why they should be entitled to be paid in full any more than I. In case of bankruptcy I would lose the entire capital structure.

Q. You were responsible for the business and you had started the business and—

A. And followed—

Q. And you had incurred the debt.

A. And followed it through, to the best of my ability.

Q. Now, Mr. Carpenter, at the time this building contract was entered into in July of 1941, you

(Testimony of Harry B. Carpenter.)

knew at that time that the cost would be at least forty-four thousand-odd dollars?

A. No, I think by that time in my own mind—I don't think I discussed it with anyone; in my own mind I figured it up around thirty-eight or thirty-nine.

Q. I understood you to say you always calculated your equipment would cost about the same as the cost of the building.

A. That is correct.

Q. Well, you knew then, in July of 1941, that the [171] building would cost you at least twenty-two thousand-odd dollars?

A. I also explained that by stating we made an addition to a canopy, widened it, which increased the building cost \$4,000, but didn't have any effect on the fixtures or equipment.

Q. But the actual contract called for twenty-two thousand-odd dollars, which you knew you were going to have to pay, in July of 1941, is that right?

A. That is right. What I am trying to explain is that the building could have been built, according to the first bid, if we hadn't increased the size of the canopy, which had nothing to do with increasing the cost of the fixtures, which were setting inside the building.

Q. I am not talking about any additions that were decided to be made after you entered into this construction contract in July. If the construction contract in July called for \$22,000, then you would calculate that the cost would be at least \$44,000.

(Testimony of Harry B. Carpenter.)

A. No, because the building could have been built for \$18,000. I could have accepted the bid that he gave me of \$18,000, but I wanted to give my customers more shade, so I increased the size of the canopy.

Q. But you didn't accept that bid of \$18,000, you entered into one of twenty-two thousand-odd dollars. [172]

A. That is correct, but with an additional \$4,000 that didn't affect the fixtures in any way.

Q. I am not talking about the addition—

A. I am.

Q. —to the \$22,000. That would make it \$26,000. I am talking about the basis of \$22,000.

A. The difference between the \$18,000 and the \$22,000, Mr. Maiden, is the \$4,000; I insisted on building a wider canopy.

Q. I beg your pardon.

A. See what I am trying to get at?

Q. No. I thought that came along later on.

A. No.

Q. I believe the evidence showed that the stock certificates were not issued, at least, prior to November of 1941. A. Correct.

Q. As of that time you gentlemen knew that the cost of opening the business would approximate \$55,000? A. That is correct.

Q. Now, so far as controlling that corporation was concerned, it didn't make any difference to you from a practical standpoint whether the corporation issued 1,000 shares of stock or 7,500 shares of stock, did it?

(Testimony of Harry B. Carpenter.)

A. I will ask you to repeat that.

The Court: Read the question. [173]

(The question was read.)

The Witness: I will have to go back to the same credit proposition on the notes and the loan.

By Mr. Maiden:

Q. Well, Mr. Carpenter—

A. That was no control; no one controlled the corporation.

Q. I mean this, though: that you stockholders would have had just as effective control of this corporation by holding 10 shares apiece as you did by holding the 3,000 shares which were issued.

A. Yes, I would say we would.

Q. Now, did I understand you to say that one reason why you took part of your advances in notes was that in some of these other corporations that you were a minority stockholder?

A. I was a minority stockholder in all of them.

Q. You were a minority stockholder in this corporation? A. I was.

Q. Who was the majority stockholder?

A. There was none.

Q. Didn't you hold as much stock in this corporation as any other individual?

A. That is right. [174]

Q. And you were president of the corporation?

A. That is right.

Q. You were chairman of the board of directors, is that right? A. I think so.

(Testimony of Harry B. Carpenter.)

Q. Were you on an equal stock basis with any of the stockholders in the other corporations?

A. Well, counting Mr. Lyman and Mr. Simon as a unit, I was not, no. I probably was on an equal with some, if that is your question, but in some corporations there was no control.

The Court: Read the question.

(The question was read.)

The Court: I am not sure that is what you mean. You mean you were equal with some of them?

The Witness: I mean there may have been some stockholders in some of the corporations that didn't hold any more of the stock than I did. There were always some in the Simon corporations that held more than I held.

The Court: Proceed.

By Mr. Maiden:

Q. Mr. Carpenter, did you ever discuss with Mr. Odell the tax benefit of this type of an arrangement?

A. I don't think so. Mr. Odell and I never talked taxes. [175]

Q. Well, he was your tax man, wasn't he?

A. No, he was not.

Q. He was not? A. Not at any time.

Q. Well, I want to know whether or not you discussed with Mr. Odell, or Mr. Odell discussed with you, this arrangement, and whether or not you could get away with it.

A. No, because we had used this same thing in

(Testimony of Harry B. Carpenter.)

many instances prior to this, and there was no reason for us to think there was anything wrong with it.

Q. I believe it is stipulated in this case the Government has refused to accept this arrangement in these other corporations, and that you now have cases appearing before this Court involving this same issue, is that right?

A. I don't think in all of them; in some of them, yes.

Q. Well, the stipulation will show that.

Now, Mr. Carpenter, you say you don't know anything about the books of this corporation?

A. No.

Q. You never had known anything about them?

A. No, wouldn't know them if you showed them to me.

Q. You never did look at the books?

A. Yes, I have had them point out certain items for me. Some question might arise as to why something cost so much.

Q. Who was in charge of keeping your books in 1941? [176]

A. Well, the girl in my office, Mrs. Jennings.

Q. Mrs. Jennings, is she now with you?

A. No.

Q. How long has she been out of your employment?

A. Well, I will have to guess; I would say five or six years.

Q. Are you aware of the fact that your books

(Testimony of Harry B. Carpenter.)

during 1941 and up until Mr. Aye came into the picture in April of 1942 did not show any notes payable to the stockholders?

A. No, I don't know.

Q. You were not aware of that?

A. No. I would like to explain here, Mr. Maiden, that prior to this time that I had operated in the restaurant business since I was a youngster and that during that entire time I paid everything by cash every day, and the only checks we had to write up in our office or books we had to keep were the utilities that came in the first of the month, and the rent, and possibly some large equipment that would come in there and there wouldn't be enough cash in the register to pay for it.

With the Social Security and the increasing number of places that I was operating—this made seven at that time—it became necessary for me to change over entirely and pay on a monthly basis or semi-monthly basis and deposit all the money in the bank. This was my first experience in ever [177] carrying out anything but a cash business.

Q. Well, you had taken care of the financial operations of these other businesses by yourself then? A. That is right.

Q. You didn't keep any books?

A. I kept most of my—most of my bookkeeping was done on a checkbook.

Q. You kept that yourself?

A. I wrote all the checks and signed them myself, up until the time this other arrangement took effect, April of '42.

(Testimony of Harry B. Carpenter.)

Q. When did you discover that your books for 1941 didn't carry notes payable to stockholders?

A. Since I came in this courtroom.

Q. Since you came in this courtroom?

A. Yes.

Q. You mean to tell me that today is the very first time— A. Yesterday.

Q. Yesterday was the first time that you were apprised of the fact that your 1941 books didn't show any notes payable to the corporation—

A. That is correct.

Q. I mean to the stockholders.

A. That is correct. [178]

Q. How long have you known about the pendency of this lawsuit?

A. I don't get the word; I don't understand it.

Q. You have been in controversy with the Government— A. That is right.

Q. —about this matter for some time, haven't you?

A. Yes. Ever since the examination was made. We were notified that the Government had taken exception to this note proposition.

Q. Didn't anyone ever tell you, in discussing this matter and preparing it for trial, about the fact that your books had been changed in 1942 to show the note obligations? A. No.

Q. You didn't discuss the case with your lawyers?

A. I discussed the case very fully with my lawyers. This particular thing never came up.

(Testimony of Harry B. Carpenter.)

Q. Did your lawyers ask you to furnish them with certain facts relative to the books as they were in 1941 and as they were changed in 1942, for the purposes of entering into a stipulation with the Government?

A. No, sir. Those negotiations were all carried on with Mr. Aye's office.

Q. You mean to tell me that when you employed Mr. Aye, that he didn't tell you about this omission, if it was an omission, from the 1941 books?

A. If he told me, I can't remember it. I think I would remember it.

Q. He never discussed it with you at all?

A. The fact that the notes weren't on the book?

Q. Yes. A. No, he did not.

Q. He never told you that the entire amount of money advanced by you men to this corporation was set up as capital investment?

A. I don't think it was. If it was, I hadn't heard of it.

Q. You say you don't think it was?

A. I don't think it was set up on the books as \$55,000 capitalization.

Q. What makes you make that statement?

A. Well, I am answering truthfully what I believe to be a fact.

Mr. Maiden: Counsel, is this the same book you had here yesterday?

Mr. Webster: Yes, it is.

Mr. Maiden: Are there any pages that have been removed since yesterday?

(Testimony of Harry B. Carpenter.)

Mr. Webster: None. Can I help you?

Mr. Maiden: Yes.

By Mr. Maiden: [180]

Q. I refer you here to this page in this book that has been identified as the ledger account of the corporation, to an entry of December 31, 1941, and the name of this account is "Stock subscriptions receivable." A. Yes.

Q. I will ask you if that doesn't show a credit of \$55,000 and a charge of \$55,000?

A. That is correct. But I still don't see where it says anything in regard to capital stock or notes, either way.

Q. This says, "Stock subscriptions," doesn't it?

A. Yes, it does.

Q. I will ask you if the "55" figures haven't been marked through with a pencil and the figure "30" put above it in each instance.

A. That is correct. I also say I never saw that entry before.

Q. You never saw it before. You would say this is the first time you have seen that sheet?

A. Yes.

Q. You have never gone through this ledger sheet?

A. I didn't say that. I say at certain times I might ask questions and have them point it out to me. They are still Greek to me.

Q. In preparing this case for trial, you haven't been asked by your counsel or anyone to familiarize yourself with [181] the facts?

(Testimony of Harry B. Carpenter.)

A. The only statement I had made to me by counsel with regard to the \$55,000 was that Mr. Whittaker in error, in making out the 1941 income tax, had put it on the tax statement as \$55,000. The book was never mentioned to me.

Q. What about Mr. Whittaker's error?

A. He had made an error.

Q. Who told you that?

A. Some of my associates.

Q. Mr. Whittaker didn't tell you that?

A. No. Mr. Whittaker didn't tell me that. I said the only \$55,000 that was mentioned to me, or each time it was mentioned to me, was in connection with that 1941 income tax return.

Q. Now, Mr. Carpenter, I believe you stated that you received a note from this corporation and a stock certificate after, sometime after, the meeting that you had in Mr. Odell's office on, I believe, November 13, 1941.

A. I think I stated that I received the stock certificate and note in early December.

Q. In early December? A. Yes.

Q. Did you actually receive that note and that stock certificate in December? [182]

A. Just as true as I am sitting here.

Q. That is true of 1941? A. That is right.

Q. What did you do with your note and your stock certificate when you received it?

A. Took it directly to the safe deposit box where it remained until this week.

Q. You mean to tell me you didn't exhibit that

(Testimony of Harry B. Carpenter.)

note to the bookkeeper of the corporation for recording?

A. No, sir, didn't know it was necessary.

Q. You never did advise the bookkeeper of the corporation that you had such a note?

A. I advised my accountant.

Q. Who was that? A. Mr. Aye.

Q. When was that?

A. I don't remember.

Q. Well, it would be sometime in 1942?

A. Yes, sometime in 1942.

Q. Sometime in 1942. This note that you received bears date of November 13, 1941.

A. That is right.

Q. Was that the actual date that the note was issued, Mr. Carpenter?

A. Yes, it was the day it was issued. Whether it was [183] the day I signed it or not, I don't remember. We had our meeting, I think, on the 13th. Odell was instructed to go back and draw up the notes and issue the stock, and I think the following day my son and I went down and we both signed the notes.

Q. Well, now, when would you say that in point of time it was that Mr. Odell drew up the notes?

A. The 13th.

Q. Of November? A. Yes, sir.

Q. Well, now, in point of time, when would you say that you signed the notes? A. The 14th.

Q. The 14th? A. That is right.

Q. Now, then, you were president of the corporation and your son was secretary and treasurer?

(Testimony of Harry B. Carpenter.)

A. That is right.

Q. And the minutes of the corporation required that you and your son sign those notes?

A. Us assign them, did you say?

Q. Yes. A. No, they weren't assigned.

Q. I said "signed."

A. Yes, signed. [184]

Q. I believe there has been offered in evidence a letter bearing the signature, according to your testimony, of Mr. Odell. I believe that letter is dated December 5, 1941. Can you explain to me why it was necessary for Mr. Odell to mail you that note when, in the first place, you had to sign your own note as an officer of the corporation?

A. Well, he mailed the note, the stock certificate, and a bill for his services.

Q. I want to know why it would be that Mr. Odell would have to mail you your note when you had to sign it yourself.

A. I expect you will have to ask Mr. Odell that question.

Q. Do you have any idea why it is that Mr. Odell didn't send you that note until the purported date of December 5, 1941?

A. I wouldn't have the least idea, sir.

Q. Well, can you tell the Court that you signed this note, your own note, and then turned the note over to Mr. Odell? A. I certainly did.

The Court: Counsel, we are going to recess now until 1:45.

(Whereupon, at 12:10 p.m., a recess was taken until 1:45 p.m. of the same day.)

Afternoon Session—1:45 p.m.

The Court: Proceed with the cross examination.

Whereupon,

HARRY B. CARPENTER,

called as a witness for and on behalf of the Petitioner, having been previously duly sworn, resumed the stand and testified further as follows:

Cross Examination (Continued)

By Mr. Maiden:

Q. I believe the last question I asked you, Mr. Carpenter, was whether or not you executed your own note as an officer of the corporation and then turned it over to Mr. Odell, and I believe your answer was, "I certainly did," or that you did do that. A. I did that.

Q. Now, I wonder why it was necessary for you to turn your own note over to Mr. Odell and then have him redeliver the note to you.

A. Because in the majority of instances I left a lot of my papers with Mr. Odell, I imagine, and another thing, I don't think Mr. Odell would have permitted me to have my note until they were all made at the same time or delivered at the same time. As I explained, he was very particular in all his dealings and insisted on things that other attorneys didn't.

Q. Now, Mr. Carpenter, why was it that you issued notes [186] for only half of the amount of the advances that you made to this corporation?

A. Well, it seemed the right thing or the nor-

(Testimony of Harry B. Carpenter.)

mal thing to split it fifty-fifty. I think that had been done in the past in some of the other corporations.

Q. I believe you stated that you were interested in becoming a creditor of the corporation so that if the corporation failed, you would have a creditor's claim? A. That is right.

Q. Well, why wouldn't you have wanted to have taken as much or more of the advancement in notes rather than in stock?

A. Well, the principal idea was to have a stable corporation, one that, if it became necessary to go out in the open market and borrow money, it could be done.

Q. Well, I know, but why didn't you take two-thirds—notes for two-thirds of it, and then a third of it in stock?

A. Because it wouldn't have been as good as a bank loan had we had to borrow money from a bank, as it was with 50 per cent in notes and 50 per cent in stock.

Q. Was that the reason why you did it on the fifty-fifty?

A. That was one of the reasons, and I can't think of the rest.

Q. Well, didn't you realize that when you took 50 per cent of your advancement in notes, that that would hurt you in any credit arrangements with banks for the corporation, [187] to show those notes payable? A. I don't think it would.

Q. Well, why would it, then, if you had taken two-thirds of it in notes and a third in stock?

(Testimony of Harry B. Carpenter.)

A. Well, it seemed the right thing to do, to take 50 per cent.

Q. Well, I want to know why it seemed the right thing to take 50 per cent.

A. Well, that is the only answer I could give you, sir.

Q. Now, Mr. Carpenter, I believe you stated that you did not read the 1941 return of the corporation.

A. That is correct.

Q. But signed it without reading?

A. Or any of the other years.

Q. Or any of the other years?

A. That is right.

Q. You haven't, to this day? A. No.

Q. This 1941 return required that it be sworn to, Mr. Carpenter?

A. That is right.

Q. Did you swear to it before a notary public?

A. Yes.

Q. Do you mean to tell me that you are accustomed to swearing to things which you haven't read? [188]

A. That is prepared by people that I have my trust in, yes.

Q. Then, the statement on this 1942 return, which reads that, "We the undersigned, president or vice-president or other principal officer and treasurer or assistant treasurer or chief accounting officer of the corporation for which this return is made, being personally duly sworn, each for himself deposes and says that this return, including any accompanying schedules and statements, has

(Testimony of Harry B. Carpenter.)

been examined by him and is to the best of his knowledge and belief a true, correct, and complete return made in good faith for the taxable year stated pursuant to the Internal Revenue Code and the regulations issued thereunder."

Then, that was not a correct statement on your part, is that correct?

A. Everything happened as exactly I told you.

Q. Well, on this return you swore that you had read the return, and now you state that you didn't read the return.

A. I didn't read the return.

Q. So then, to that extent, your oath is false?

Mr. Shearer: I object on the ground it calls for a conclusion of the witness, if your Honor please.

The Court: The objection is overruled. Exception allowed.

The Witness: Yes. [189]

By Mr. Maiden:

Q. Now, Mr. Carpenter, you stated that Mr. Whittaker left you in the spring of 1942?

A. That is correct.

Q. And I believe you gave the reason for his leaving, your dissatisfaction?

A. That is right.

Q. Now, why were you dissatisfied with Colonel Whittaker?

A. Well, in preparing the state income tax return for me which I signed and paid as I did these, he had the state tax almost as much as the federal.

(Testimony of Harry B. Carpenter.)

After he left, and I examined my copy, I called him and asked him if the state tax wasn't supposed to be approximately 25 per cent of the federal tax. His answer was that it is in most instances, but it also doesn't work out that way. So, having written the check for the large amount, I became suspicious and took my copy of the state income tax return down to a friend of mine who is also an accountant, a fellow by the name of George Temple, and Ira Thomas. Temple is Shirley Temple's father. They looked at it and—I took both the federal and the state returns down—they looked at it and recomputed it and there was an error of several thousand dollars. That was the first thing, and we had several little disagreements as we went along, and when he left, we didn't part the best of friends. [190]

Q. Well, then, at that time when you carried the state and federal returns down to this other accountant and went over it with him, didn't you discover the fact that the return reported the entire \$55,000.00 investment as capital stock on your federal return?

A. It was a prior year, it wasn't this year.

Q. It wasn't this year? A. No.

Q. Now, Mr. Carpenter, as president and chief executive officer of this corporation, didn't you feel a responsibility with respect to seeing that the books of the corporation properly reflected its operations?

A. I would have been very happy to, if I could

(Testimony of Harry B. Carpenter.)

understand them. As I explained to you, I worked on a cash basis all my life and knew no other way, and this frightened me very much when I was forced to change over to the monthly payments and sign several checks a month.

Q. Well, didn't it occur to you that you should tell your bookkeeper that this corporation had issued notes for part of this advancement and stock for the other, so that that could be recorded on the books?

A. I didn't know it was necessary to record it on the books. The books, to me, were just like the income tax returns, I couldn't understand them if I looked at them and I examined them. [191]

Q. Did you ever ask the bookkeeper to explain the books to you, to see that everything was going on the books in a proper manner?

A. I warned them many times, but I didn't ask to see the books, only in particular instances where something appeared too high.

Q. Now, Mr. Carpenter, I will ask you if it wasn't your intention prior to the issuance of this stock to issue stock of the corporation sufficient to cover the essential costs of operating the business.

A. No, it was not.

Q. It was never your intention to issue sufficient stock to cover the cost of building this drive-in and equipping it for business?

A. Never at any time.

Q. You never had that in mind?

A. Never.

(Testimony of Harry B. Carpenter.)

Q. Did you ever discuss it? A. No, sir.

Q. That you might do that?

A. No, sir; we followed the same procedure in this case that we had in previous corporations, or approximate.

Q. Now, then, Mr. Carpenter, I want to show you Exhibit 4-D to the stipulation in the case, which is an application filed with the Corporation Commissioner, and I call your [192] attention to paragraph VIII on page 3, which states, among other things, on page 4, that:

“ . . . It is proposed also to sell additional of its stock for cash and to the incorporators if it should become necessary to do so for the purpose of meeting the building or equipment or for further expanding the business or facilities thereof . . . ”

What do you know about that, Mr. Carpenter?

A. Not a thing.

Q. You never heard of that before?

A. No, sir.

Q. I will ask you if this exhibit didn't show that you signed this application for the corporation.

A. I signed the application for the corporation personally.

Q. And I will ask you if it doesn't show that you likewise filed it under your oath?

A. Yes.

Q. As appears on page 8?

A. That is correct.

Q. Now, this oath states:

“Harry B. Carpenter, being duly sworn on oath

(Testimony of Harry B. Carpenter.)

deposes and says that he is President and one of the directors of Wilshire and Western Sandwiches, Inc., a corporation, mentioned in the within application, and knows the contents thereof and that the statements [193] therein are true."

Was this just another case of your swearing to something without knowing what you were swearing to?

A. That is right, prepared by someone that I had confidence in.

Q. Now, Mr. Carpenter, I call your attention to the stipulation again, page 9, which shows the corporation Simon's Florat, the capital structure being \$10,000.00 in stock, \$38,097.09 in notes. Now, that is not split up fifty-fifty, is it? A. No.

Q. Well, why didn't you use your fifty-fifty plan in the Simon's Florat?

A. I have no answer for that. I had nothing to do with the incorporating and am not an officer or director.

Q. Well, you became a stockholder and an investor?

A. I was very happy to buy stock in any enterprise that Mr. Simon opened up, because I had the utmost faith in his ability, integrity, and brain power.

Q. Well, why did you take part of your investment in that corporation in the form of a note?

Mr. Webster: Your Honor, I will object to the form of that question, if I may.

The Court: What is the ground of your objection?

(Testimony of Harry B. Carpenter.)

Mr. Webster: The use of the word, the use of the [194] phrase, "take part of your investment in that corporation in the form of a note." This is the very issue that we are talking about.

The Court: I will sustain the objection to the question in that form.

By Mr. Maiden:

Q. Mr. Carpenter, why did you, if you were glad to have stock in any corporation of Mr. Simon's, why did you take part of your money advancement to that corporation in note?

A. Because that was the way it was set up.

Q. You disclaim any tax motive, Mr. Carpenter?

A. Yes, sir.

Q. I believe you stated you didn't even think about taxes when this plan was conceived and carried through in all these corporations?

A. I think my answer to that was that the plan would have been carried through if the tax feature wasn't there, as I remember my answer. I don't deny that I knew the tax feature was there.

Q. But did you deny that the tax feature influenced you? A. I did, because—

Q. And you now deny that?

A. I now deny that. [195]

Q. Emphatically? A. Emphatically.

Q. Mr. Carpenter, is it a fact that you were indicted in the Federal District Court in California for filing false and fraudulent individual income tax returns and false and fraudulent partnership returns for a concern by the name of Carpenter's Drive-In?

(Testimony of Harry B. Carpenter.)

Mr. Webster: Your Honor, I object to the question on the ground that it is outside of the issues of this case.

The Court: Well, of course, certain questions, even though they are outside the issues of the case, are competent for purposes of impeaching the credibility of a witness. What do you say to that?

Mr. Webster: I would like to know for what purpose the question is being asked.

Mr. Maiden: For impeachment purposes, of course.

The Court: If that is your only reason for objecting, the objection will be overruled and exception allowed.

The Witness: I was.

By Mr. Maiden:

Q. Were you convicted, Mr. Carpenter?

A. I entered a plea of *nolo contendere*.

Q. What is that?

A. I entered a plea of *nolo contendere*, if that is the correct term. [196]

Q. Did you pay a fine? A. I did.

Q. Did you receive a jail sentence or penitentiary sentence? A. I did not.

Mr. Maiden: I believe that is all, if the Court please.

Redirect Examination

By Mr. Webster:

Q. Mr. Carpenter, I show you the 1941 income tax return of the corporation, Joint Exhibit 8-H, and I ask you with respect to the fine print just

(Testimony of Harry B. Carpenter.)

above your signature on that return, which Mr. Maiden read to you, whether you read that fine print at the time you signed the return.

A. I did not.

Q. You did not? A. No.

Q. Did you know the contents of that fine print at the time you signed the return?

A. Oh, in a general way. I knew that I was signing that the return was correct.

Q. Mr. Carpenter, with respect to the oath which was attached to the application to the Corporation Commissioner for a permit to issue shares, which was previously shown to you by Mr. Maiden, had you read that? [197]

A. I read it over in a general way. I would say that I skipped through it, probably.

Q. Mr. Carpenter, you have testified to receipt of a letter from Mr. Odell, dated December 5, 1941, a portion of that letter, the last paragraph states:

“We enclose statement for services and expenses which we trust you will find entirely satisfactory.”

Is that true? A. Yes.

Q. I show you a bill from Tanner, Odell & Taft, dated December 4, 1941, and ask you if you have seen this bill before.

A. Yes, that accompanied this letter.

Q. Do you know whether that bill was paid?

A. It was, by check.

Q. Who is H. B. Carpenter, Jr?

A. My son.

Q. Do you recognize his signature?

A. Yes.

(Testimony of Harry B. Carpenter.)

Q. I ask you if this is his signature.

A. Yes.

Q. Is this the check which paid the attorneys' bill?

A. Yes.

Q. The date of this check is January 30, 1942, and the perforation date shows that it cleared through the bank on February 2, 1942. Did you understand from the contents of the bill the services which had been rendered and for which the bill was being presented?

A. I did.

Q. What did those services include?

A. It says: "For legal services in connection with incorporation permit, lease and all related matters, revenue stamps and messenger service."

Q. And that was with respect to—

A. Wilshire and Western.

Mr. Webster: I offer this as Petitioner's exhibit next in order.

The Court: Why does that have any importance to this case, counsel? I heard no objection, but I would like to know your arguments why that furthers your case.

Mr. Webster: Your Honor, Mr. Maiden asked Mr. Carpenter on cross as to the fact of whether Mr. Odell actually sent the December 4th letter—December 5th letter, 1941, on the date which the letter bore, and whether he received it in the due course of mail. Mr. Carpenter answered the question that he did receive it in the ordinary course of mail. A way of substantiating that would be to establish that the bill which was included in the

(Testimony of Harry B. Carpenter.)

letter of transmittal was actually paid a few months later.

The Court: I see. [199]

The Clerk: No. 28.

The Court: Petitioner's Exhibit No. 28 is admitted in evidence.

(The document above-referred to was received in evidence and marked Petitioner's Exhibit No. 28.)

By Mr. Webster:

Q. Mr. Carpenter, you were asked concerning a Federal and a California tax return which Mr. Whittaker had prepared, which you took down to a Mr. Temple, I believe. A. Mr. Thomas.

Q. Mr. Thomas—and both of them indicated that the State return was in error?

A. That is right.

Q. What return were you talking about?

A. My personal State return.

Q. It had nothing to do with Wilshire and Western?

A. Oh, no, this was before Wilshire and Western was organized.

The Court: You mean by that, Mr. Witness, that it was for a year prior to that?

The Witness: No, I think it was two years prior to that.

The Court: Well, when did it come up, this matter and your dissatisfaction with Mr. Whittaker?

The Witness: It started at that time. [200]

(Testimony of Harry B. Carpenter.)

The Court: The words "at that time" are still indefinite. When did your dissatisfaction arise with reference to the time of formation of the corporation which we have here?

The Witness: Well, it dated back from this State franchise return. There were some other things that came up, but I can't recall them. That one was a larger amount and remains in my mind.

The Court: Proceed.

Mr. Webster: That is all, your Honor.

Recross Examination

By Mr. Maiden:

Q. You stated that the question of the error in your State personal tax return, that your discovery of that error occurred prior to the formation of this corporation? A. Yes.

Q. I believe you stated that that was the reason why you became dissatisfied with Mr. Whittaker.

A. No, I said there were numerous things that came up.

Q. So that that wasn't the reason why you parted company with Mr. Whittaker?

A. Not entirely.

Q. In the spring of '42? A. Not entirely.

Q. Does Mr. Whittaker do the tax work for Mr. [201] McDonnell now?

A. I think not. He did at the time I started with Whittaker. In fact, that was the reason I happened to go to Mr. Whittaker in the first place.

Q. Do you have any explanation at all to offer the Court why your bookkeeper would have entered

(Testimony of Harry B. Carpenter.)

on the books of this company in 1941 the fact that this entire \$55,000.00 advance was a capital investment for which stock was to be issued?

A. I don't know it to be a fact, but I imagine Mr. Whittaker advised her to.

Q. Didn't you hear Mr. Whittaker testify that he didn't see the books, that all he did was prepare an outline and send it out to the company, and he didn't see them again until he went out to take a trial balance of all the books?

Mr. Shearer: I object to that question on the ground it misstates the evidence. Mr. Whittaker distinctly testified he recognized certain pages, if your Honor will recall, as having been typed in his office, the book which we are talking about.

Mr. Maiden: That was the opening journal entry, your Honor, that he put in there at the very first. He stated that he didn't see the other pages in the book.

The Court: Will you read the question, please?

(The question was read.) [202]

The Court: The objection is overruled.

The Witness: I don't remember what Colonel Whittaker's testimony was, all of it. I do feel confident that \$55,000.00 wasn't entered by my bookkeeper, although her initials are in there.

By Mr. Maiden:

Q. What makes you feel confident it wasn't entered by your bookkeeper?

A. Isn't it typewritten?

Q. No, it is not.

(Testimony of Harry B. Carpenter.)

A. If it is in typewriting, it wasn't entered by her, because they don't use the typewriter.

Q. Now, on this Account No. 1032, entitled "Stock Subscriptions Receivable," I will ask you if the postings in there aren't in ink.

A. That is right.

Q. You recognize that handwriting, Mr. Carpenter? A. No, I don't.

Q. Now, I will also call your attention to—

A. This handwriting here (indicating) looks very much like the lady that was working for me in the beginning, but this (indicating) doesn't.

Q. Now, I will also call your attention to Account No. 302.

The Court: Now, Counsel, I call your attention to [203] the fact that the word "this" is very indefinite, and just from hearing the words "this is" so and so and "this is" so and so, I won't know what that testimony means.

By Mr. Maiden:

Q. Coming back to Account No. 103, under date of 1941, being put in in ink, under that December 31 in ink, posting reference J-3 in ink, and under word "Credit," \$55,000.00, and then likewise, December 31, ditto for posting reference in ink, \$55,000.00. Now, do you know whose handwriting that is? A. No, I do not.

Q. You do not?

A. As I say, these initials by the side of it look like her handwriting, but the words "Post for credit, refund of excess profits tax," don't look like her handwriting. It could be.

(Testimony of Harry B. Carpenter.)

Q. I believe the "55" in each one of these figures of \$55,000.00" has been marked through with a pencil and, in pencil, "30" has been entered above the "55", is that right? A. That is right.

Q. Now, calling your attention to Account No. 302 in this ledger book that has been identified as being the ledger book of the corporation, designated "Stock Unissued," I will ask you if this doesn't bear an entry under 1941, March 24, and under the column "Charges," \$75,000.00, and then if under [204] that it doesn't bear the date December 31, and following that, \$55,000.00, which has been run through with an ink mark, and if under the column "Credits" \$55,000.00 doesn't appear in ink, and the "55" has been marked through and "30" put above it. A. That is right.

Q. I will ask you if, under the column "Balance," there isn't a figure in pencil of \$45,000.00.

A. That is right.

Q. Do you know whose handwriting that is?

A. No, but I imagine it is Mrs. Jennings, my bookkeeper.

Q. You have no explanation to offer as to how she could have made those entries?

A. No, unless Mr. Whittaker advised her to. That is the general procedure in my office, for the auditor to have the bookkeeper enter them in the ledger, or the accountant do it himself.

Q. Did you have an auditor at that time, in 1941? A. I had Mr. Whittaker.

Q. Well, I understood Mr. Whittaker to testify that he was not in charge—

(Testimony of Harry B. Carpenter.)

A. I am in error. I guess I called him in as an auditor on Wilshire and Western.

Q. Simply for the purpose of setting up—

A. A set of books. [205]

Q. Set of books?

A. Which, by the way, is the first set of books I ever had.

Q. I believe Mr. Whittaker testified, in addition to typing the opening statements in your journal, that he sent you a list designating the entry number, account number, and the title of the account, and that that is all he had to do with the books.

A. That I don't remember. Now, I think he said—

Mr. Shearer: Just a minute, please. I object to the question, which is not a question but simply a statement of what Colonel Whittaker was supposed to have testified to and which is a matter of record here.

Mr. Maiden: Your Honor, I have got a right—

The Court: The objection is overruled; exception is allowed.

The Witness: I think he said his son came out and typed some pages in the ledger.

By Mr. Maiden:

Q. What?

A. I think he said his son came out and typed some pages in the ledger. I don't remember his son ever coming out, but that is what he stated and probably is true.

Q. Of course, his testimony is in the record, and I may have been wrong about it. [206]

(Testimony of Harry B. Carpenter.)

A. Well, I am sure he mentioned his son.

Q. I believe he stated that his son took off the trial balance?

The Court: Well, let's not discuss the evidence any further. It is there for whatever it states.

Mr. Maiden: I believe that is all, if the Court please.

The Court: Anything further from this witness?

Mr. Webster; Nothing, your Honor.

The Court: Do both sides agree to excuse the witness from further attendance in this case?

Mr. Maiden: As far as the respondent is concerned.

Mr. Webster: Yes.

The Court: You are excused from further attendance.

(Witness excused.)

Whereupon,

ELIAS J. AYE,

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you tell us your name?

The Witness: Elias J. Aye.

Direct Examination

By Mr. Webster:

Q. Mr. Aye, what is your occupation? [207]

A. I am a member of the California State bar and a certified public accountant.

(Testimony of Elias J. Aye.)

Q. How long have you been in practice?

A. Since—in law practice?

Q. Well, let's break it down, then. How long in law practice?

A. Well, I was admitted to the State bar in 1913 and I passed the C.P.A. examination in 1918.

Q. Are you in the active practice of both of those professions at the present time?

A. Well, I would say I am retired. I still do a little work.

Q. Were you active in 1941? A. Yes.

Q. We have had testimony to the effect that a client of yours in 1942 for accounting purposes was Wilshire and Western Sandwiches, is that correct? A. Yes.

Q. When did you first commence working with them as a client?

A. I believe it was April or May, 1942. It was after the tax season, I know that.

Q. Can you recount for the Court the circumstances under which you acquired Wilshire and Western Sandwiches as a client? [208]

A. William H. Simon and Mike Lyman, clients of mine since about 1918 or '19, and Mr. Simon told me that he wanted me to go out and take a look at this Wilshire and Western set of books and see what they had, that he didn't have confidence in the man they had out there, and he wanted to know what was on the books.

Q. Did he mention to you the name of the man whom they had out there?

A. Yes, I think he did.

(Testimony of Elias J. Aye.)

Q. Do you remember the name?

A. Colonel Whittaker.

Q. You say you went out there in April or May of 1942?

A. Yes.

Q. What was the first thing which you did when you got out there?

A. Well, I imagine the first thing I did was to try to get a trial balance on the general ledger.

Q. Do you recall as of what date?

A. No, I wouldn't recall that now.

Q. Was it around the time at which you went out there?

A. Yes, it was a current trial balance.

Q. Do you recall the results of that attempt to take a trial balance?

A. Well, being acquainted with Mr. Simon's business, I knew that he had taken notes from the Wilshire and Western [209] Sandwiches—Wilshire and Western Corporation—and they showed no notes on the books at all. I knew that all of the contributors to the stock out there had notes, too.

Q. Having found that out, what was your next step?

A. Well, I went back and talked to Mr. Simon and talked to Mr. Carpenter and they agreed that it was wrong, and to dig into it and straighten it out.

Q. Did you attempt to take a trial balance at an earlier date?

A. Well, they had a trial balance at an earlier date.

Q. What date was that?

(Testimony of Elias J. Aye.)

A. Well, they had the trial balance at the end of the previous year.

Q. That would be December 31, 1941?

A. Yes.

Q. I believe these are your working papers which you used in connection with your work at Wilshire and Western, is that correct?

A. Yes, that is correct.

Q. Did you personally prepare those working papers?

A. Yes, these are in my own handwriting.

Q. You stated you took a trial balance as of December 31, 1941. What was the result of that trial balance?

A. Well, the trial balance did not reflect the notes which the corporation had issued. It misstated the amount of [210] capital stock outstanding.

Q. Can you see anything else in that trial balance which was in error?

A. Yes. They had a number of refunds shown as income, and I asked Mr. Carpenter how a concern just starting in business could have a lot of refunds, what they were from, and I finally got him to spend enough time with me to look at them, and he said, "Oh, those are in connection with the business which I had on the old stand. Those are mine. They don't belong to this corporation."

I said, "All right, I will take them out."

Q. Is that what you did?

A. Yes. Then I set up the notes and set the

(Testimony of Elias J. Aye.)

capital stock up the way the stock had been issued in accordance with the permit from the Corporation Commissioner.

Q. Did you examine the 1941 tax return which had been filed? A. Yes.

Q. That is, the retained copy of it?

A. Yes, sir.

Q. What did you conclude with respect to its accuracy?

A. Well, it was inaccurate as to the things which I mentioned, and I prepared an amended return and filed that with the Collector of Internal Revenue, and a copy with the State Franchise Tax Commissioner. [211]

Q. Do you recall the manner in which you filed the amended return with the Collector of Internal Revenue?

Mr. Maiden: Has he testified that he did file one?

Mr. Webster: Yes, he did.

The Court: He stated he did, a moment ago.

Mr. Maiden: All right.

The Witness: I mailed it in, my office mailed it in.

By Mr. Webster:

Q. Mr. Aye, I show you a 1941 "Corporation Income and Declared Value Excess-Profit Tax Return," which is in pencil, and ask you whether you can identify the handwriting.

A. Yes, that is my handwriting.

Q. The statement at the top of the form reads, "Amended return," is that your handwriting?

(Testimony of Elias J. Aye.)

A. Yes, it is.

Q. Do you recall preparing this form?

A. Very well.

Q. Do you recall the date at which you prepared this form?

A. Well, it was possibly May of 1941.

Q. May of 1941? A. '42, pardon me.

Q. Mr. Aye, I show you a typewritten form of 1941 "Corporation Income and Declared Value Excess-Profit Tax Return," and ask you whether you can identify this form. [212] A. Yes.

Q. What would you say it is?

A. Well, that is a corporation income tax return for the year 1941, and it was typed on a machine which we had in our office.

Q. You recognize the type of the typewriter?

A. Yes, it is an unusual type.

Q. From inspection, does it accord with the pencil copy of the return which you have?

A. Yes.

Q. Was it a duplicate or replica of this typewritten return which was sent in the mails by you to the Collector of Internal Revenue?

A. Yes, this is our retained copy.

Mr. Webster: I will offer the penciled 1941 tax return as Petitioner's Exhibit next in order.

Mr. Maiden: Your Honor, I would appreciate very much if counsel would simply offer it for identification at this time and give me an opportunity to examine Mr. Aye before stating I have no objection.

Mr. Webster: Very well, your Honor.

(Testimony of Elias J. Aye.)

The Court: Identify the instrument.

The Clerk: It is identified as No. 29.

(The document above-referred to was marked
Petitioner's Exhibit No. 29 for identification.)

Mr. Webster: I offer the typewritten 1941 corporation amended return—

Does your same request apply to this?

Mr. Maiden: Yes, but it would seem to me that one would do the trick, though. I don't see the sense of putting both in.

Mr. Webster: Just for identification.

The Clerk: It will be No. 30.

The Court: It will be marked for identification as Exhibit No. 30.

(The document above-referred to was marked
Petitioner's Exhibit No. 30 for identification.)

By Mr. Webster:

Q. Mr. Aye, Exhibit 8-H has been identified as the original 1941 tax return which had been prepared by Mr. Whittaker. The amount of normal taxable net income shown on this return is \$5,094.88. I ask you whether you can locate that amount in the general ledger of Wilshire and Western Sandwiches.

A. Yes, it is here in the journal in someone else's handwriting.

Q. Do you know whose handwriting it is?

A. No, I don't, but the entry in the ledger is in my handwriting.

Q. What entry is that? [214]

A. Setting up this earned surplus which Colonel Whittaker showed.

(Testimony of Elias J. Aye.)

Q. Do you recall whether there was a ledger sheet entitled "Earned surplus," prior to the time of your commencing to work for Wilshire and Western Sandwiches?

A. I think there must not have been.

Q. Do you know whose handwriting—

A. That is my handwriting.

Q. You are speaking now of the words "Earned surplus"? A. Yes.

Q. Under the word "Capital" in the ledger?

A. Yes.

Q. At the top of the page, that handwriting is yours? A. That is right.

Q. Would you describe for the Court the significance of the next entry underneath the entry of \$5,096.88, which you have stated you incorporated in the earned surplus ledger?

A. Those are the correcting entries which I made to take out the miscellaneous receipts and make the other adjustments necessary to have Colonel Whittaker's trial balance reflect the transactions according to the minutes of the corporation, and according to the true nature of the miscellaneous receipts.

Q. Does the second entry under the earned surplus ledger refer to these papers under the tab "Journal" appearing on [215] pages 4, 5, and 6?

A. Yes.

Q. Are these pages 4, 5, and 6 under the tab "Journal" in a handwriting familiar to you?

A. They are in my handwriting.

Q. They are in your handwriting?

(Testimony of Elias J. Aye.)

A. Yes.

Q. Do you recall when you made this journal entry of which we are speaking, that is, J-4, -5, and -6? A. Possibly in May, '42.

Q. Can you find in the "Earned surplus" ledger an account, or in J-4, -5, and -6, the amount of the net income, normal taxable income, which you arrived at as proper for the year 1941 for the corporation? A. Yes, it is this \$2,468.16.

Q. This amount corresponds with the amount on the tax return which you have previously identified? A. Yes.

Q. Mr. Aye, are you familiar with the adjustments which were made by the revenue agent in the 1941 tax return of the corporation?

A. In a general way. I didn't handle that personally.

Q. Have you ever seen a copy of the 90-day letter which was issued by the Internal Revenue service of the Treasury Department on January 31, 1946? [216]

A. No, I think I never have seen this.

Q. On page 3 of the 90-day letter is the statement that the net income adjusted for the taxable year ended December 31, 1941, is in the amount of \$2,237.18.

A. Well, I think I will have to change my answer.

Mr. Maiden: If your Honor please, I object to this witness testifying from that document. He has stated that he has never seen it before. I just don't understand the purpose of it. It relates to the taxable year 1944.

(Testimony of Elias J. Aye.)

Mr. Webster: What relates to the taxable year 1944?

Mr. Maiden: This 90-day letter I thought you were referring to relates to 1941, doesn't it?

Mr. Webster: Yes. If we are going to exclude everything that related to the calendar year 1941, we would have stricken a lot of this testimony.

Mr. Maiden: Well, if your Honor please, the tax liability of this petitioner for the year 1941 is not before the Court in this proceeding. I haven't caught the possible materiality of this examination.

Mr. Webster: If your Honor please, the abilities, the respective abilities, of the accountants employed by Wilshire and Western Sandwiches, have apparently been placed in issue.

Mr. Maiden: The respectabilities?

Mr. Webster: Respective abilities. [217]

Mr. Maiden: I haven't so conceived any such issue in this case.

Mr. Webster: Well, our claim was, and was made at the outset—

The Court: Just direct your objection to me and not to each other. I don't want a harangue and soliloquy between you, on the part of either one of you, or between you.

Mr. Webster: If your Honor please, our contention is that the original return filed by Mr. Whittaker was in error; that the amended return—

The Court: For 1941?

Mr. Webster: For the calendar year of 1941; that an amended return was filed; that this amended return corresponds within two hundred dollars or

(Testimony of Elias J. Aye.)

thereabouts of the amount which the revenue agent conceded to be correct, and that this in turn reflects upon the abilities of the accountant who was originally employed by the petitioner in this case.

The Court: Well, that is going pretty far, but I will not stop you. The objection is overruled.

By Mr. Webster:

Q. Mr. Aye, are you able to reconcile the \$2,237.18 of the 90-day letter with your \$2,468.16?

A. Not exactly, but—

If your Honor please, the reason I said I thought I [218] would have to change my answer about never having seen this before, in my own handwriting I have an amount written here which the agent shows, so I have seen it before.

Q. And with respect to the reconciliation of the two amounts, would you offhand be able to give us a reconciliation? A. Not offhand, no.

Q. Mr. Aye, it is evident one of the differences between the original tax return filed by Mr. Whittaker and the amended return which you have stated you filed, as found on the balance sheet, page 4 of the return—would you describe the nature of the difference found therein?

A. Colonel Whittaker set up the entire amount of money advanced by the stockholders for which they took notes, and for which they took stock, all as common stock. On the balance sheet which I set up, I showed \$30,000.00 capital stock and \$25,000.00 notes payable.

Q. Did you ever see the stock certificates?

A. Yes, I have seen the stock book.

(Testimony of Elias J. Aye.)

Q. You have seen the stock book?

A. Yes.

Q. Where did you see the stock book?

A. In Mr. Odell's office.

Q. Did you see any other corporate records?

A. I saw the minute book, also the stock book.

Q. When was it that you saw those?

A. When I made these changes, along, in, possibly, 1942.

Q. Did you ever see any notes of the corporation referring to either or some or all of Mr. Lyman, Mr. Simon, Mr. Carpenter, or Mr. McDonnell?

A. I know that I saw Mr. Simon's and Mr. Lyman's notes.

Q. You saw those?

A. Yes, that is how I knew this couldn't be.

Q. Mr. Aye, I wonder if you could clarify the penciled corrections to which reference has previously been made, found in Account No. 1032, the title of that account is "Stock Subscriptions Receivable."

A. Yes, those are my changes.

Q. The penciled changes are yours?

A. Yes.

Q. You are referring to a line in pencil drawn through the digits "55" and a number "30" written above?

A. Yes.

Q. Can you explain the circumstances surrounding the making of this correction?

A. This Account 1032 is "Stock Subscriptions Receivable." Whoever set this up, Colonel Whitaker or the bookkeeper, set up \$55,000.00 as stock

(Testimony of Elias J. Aye.)

subscriptions receivable, and according to the minute book and to the word of the attorney and the stockholders, it was only \$30,000.00. [220]

Q. Was it for this reason that you made the change? A. Yes.

Q. There is a posting reference opposite each one of these changes on Account No. 1032, to J-3?

A. Yes.

Q. Would you describe for the Court what you find on J-3?

A. J-3 shows a debit to stock subscriptions receivable of \$30,000.00, a credit to capital stock unissued of \$30,000.00, the original entry in both instances was \$55,000.00.

The Court: Mr. Aye, will you keep your voice up a little more, please?

The Witness: I am sorry, sir.

By Mr. Webster:

Q. The original entry you say was \$55,000.00. Do you know in whose handwriting that was?

A. No, I do not.

Q. Do you know whose handwriting made the correction?

A. That is my handwriting that made the correction.

Q. Can you place in point of time the making of this correction and the making of the correction in the Account No. 1032?

A. Well, they would be made together.

Q. All of this you have previously said you did about in May of 1942? [221]

A. That is correct.

(Testimony of Elias J. Aye.)

Q. I call your attention to Account No. 203. This account is entitled, "Advances by stockholders," and I ask you to explain to the Court what you find on that page.

A. It says "Wilshire and Western Sandwiches, Inc., Advances by stockholders," and it says, "Journal." It doesn't say which one. It must be Journal 4. I have a credit of \$25,000.00.

Q. The first credit is a credit of \$25,000.00?

A. Yes.

Q. Do you know whose handwriting that is in?

A. That is my handwriting.

Q. You have stated that the posting reference is to what? A. It is to J-4.

Q. Posting reference is to J-4. At the top of the J-4 is printed "Record of journal entries, month of"—interlined between "of" and "journal" is a word "correcting", which is in pencil. Do you recognize that handwriting?

A. Yes, that is my handwriting.

Q. And written in pencil is the date "December 31, 1941." Do you recognize that handwriting?

A. Yes, that is also my handwriting.

Q. Now, at the bottom of the page is a journal entry stating "Capital Stock, \$25,000.00 charged, and Notes [222] Payable, \$25,000.00 credit," with the legend, "To correct amount shown as capital stock issued and credit Notes Payable for difference."

Do you recognize that handwriting?

A. That is my handwriting.

(Testimony of Elias J. Aye.)

Q. You have previously stated that this page was written by you at about the same time as the other pages were corrected, is that true?

A. That is correct, these are my corrections, my correcting entries.

Q. It is this journal entry you state to which the first entry in Account 203 refers?

A. Yes.

Q. Would you kindly describe for the Court the second entry?

A. The second entry is dated February, 1942, and it says, "Bank deposit, also a credit of \$10,000.00."

Q. Do you know whose handwriting that is?

A. That is my handwriting.

Q. Can you explain what that would refer to?

A. That would be an additional \$10,000.00 advanced to the corporation by the stockholders.

Q. At what time? A. In February, 1942.

Q. Would you briefly explain to the Court what the [223] contents of the remaining entries on the page, Account No. 203, show?

A. The next entry bears the date of September 30, 1942. The posting reference is the checkbook 21, and a charge for \$10,000.00, which would indicate that \$10,000.00 had been repaid to the notes payable.

Then, the next entry is 1943, April—

Q. Pardon me, may I interrupt, Mr. Aye? Do you recognize this handwriting of the entry which you previously described?

A. No, I do not. It must be the bookkeeper at Carpenter's.

(Testimony of Elias J. Aye.)

Q. Continue.

A. The next entry is April, 1943, April 30th, check register 14, a debit of \$9,998.99.

Q. Do you recognize that handwriting?

A. That is Mr. Tompkins' handwriting.

Q. Mr. Tompkins is who?

A. Mr. Tompkins is a certified public accountant who has been associated with me for a great many years, and he took charge of the handling of this account after I had made the first entries and we had threshed it around. He ran it from then on.

Q. Would you explain to the Court the significance of this entry which you just read? [224]

A. That would mean that the corporation had returned \$9,998.99 to the notes, they paid that much on the notes to the stockholders.

Q. Would you read the next entry?

A. The next entry is made on May 31, 1944, and then in pencil after it is written "May 23," which is probably the date that the checks were dated.

Check register 65, \$10,001.01.

Q. Do you recognize that handwriting?

A. That is Mr. Tompkins' handwriting.

Q. And the significance, I take it, would be the same as the previous one?

A. That was an additional payment on the notes.

Q. Would you finally explain the last entry on the page?

A. The last entry is March 31, 1945, check reg-

(Testimony of Elias J. Aye.)

ister 11, \$5,000.00, which paid off the balance on the advances by stockholders.

Q. And that handwriting?

A. That is Mr. Tompkins'.

Q. Turn to Account No. 302, which is titled "Capital Stock Unissued," and I ask you to explain briefly to the Court what you find on that page.

A. The opening entry on this account was a debt of \$75,000.00. [225]

Q. Do you recognize that handwriting?

A. No, but it is the same handwriting that made the other opening entries. I don't know who it is.

Q. The posting reference is——

A. The posting reference is J-2.

Q. And J-2, I believe, has been previously identified as the typewritten journal entry prepared by Mr. Whittaker in his own office?

A. That is correct.

Mr. Maiden: Just a second, counsel——

By Mr. Webster:

Q. Would you kindly explain to the Court the significance of the next entry you find on Account No. 302?

A. There had previously been an entry made, a credit of \$55,000.00, which I changed to \$30,000.00 for the same reason that I changed the capital stock issued.

Q. The correction is in your handwriting?

A. Yes.

Q. Do you remember when you made that correction?

(Testimony of Elias J. Aye.)

A. The same time I made the other corrections.

Q. Can you recall any other adjustments which you made with respect to the stock and loan accounts, other than the ones which we just discussed?

A. I think that is all of them.

Q. Mr. Aye, I show you the 1942 tax return filed by [226] Wilshire and Western Sandwiches, and ask you whether you know who prepared that return.

A. Yes, that was prepared in our office.

Q. Is this your signature on the return?

A. This is my signature, yes.

Q. I call your attention to the balance sheet on the reverse side of the tax return prepared by you for the calendar year 1942. Would you kindly read to the Court the loan payable and capital stock entries that are made on that balance sheet?

Mr. Maiden: If the Court please, that return is in evidence and I think it is wasting the time of the Court to have him read off figures that appear on the balance sheet of the return which is in evidence.

The Court: We have been going into an awful lot of detail here, counsel. Why is it necessary to repeat what is in the record?

Mr. Webster: If your Honor please. I was about to ask the witness whether the reason that he prepared this 1942 return in the manner in which he did stemmed from the corrections which he made in the books.

The Court: The objection is overruled.

(Testimony of Elias J. Aye.)

Mr. Webster: Would you read the question?

(The question was read.)

The Witness: The loans payable were \$25,000.00, [227] both at the beginning and the end of the period. The capital stock was \$30,000.00 at the beginning and the end of the period.

By Mr. Webster:

Q. Were those entries on that balance sheet the result of corrections which you had made on the books of Wilshire and Western?

A. Yes, it was changed from \$55,00.00 to \$30,000.00.

Q. I show you the balance sheet on page 4 of the 1943 income tax return, and ask you to read for the Court the same entries or corresponding entries.

A. At the beginning of the year, the loans were \$25,000.00, the stock was \$30,000.00. At the end of the year the loans were \$15,001.01, the capital stock \$30,000.00.

Mr. Webster: Your Honor, at this time I should like to introduce into evidence the ledger of Wilshire and Western Sandwiches, making a motion at the same time to withdraw the same for the purposes not only of writing the brief, but for the purposes of enabling the corporation to make appropriate entries, and the right to substitute in evidence photostatic copies of all pages of the ledger accounts with respect to which we have had testimony at any time during this proceeding.

The Court: Is there any objection?

(Testimony of Elias J. Aye.)

Mr. Maiden: No objection, your Honor, except I do [228] want to be furnished with a copy of the exhibit, that is, a copy of the photostatic copies, and I would also like to have the privilege of determining which entries are to be photostated and which are not.

Mr. Webster: That privilege certainly will be granted, your Honor. At the same time I should like to request that photostatic copies of the tax return be furnished to the taxpayer.

The Court: Well, neither side has an absolute right to copies of the exhibits. The exhibits are before the Court when they are introduced in evidence, and it is just a matter of courtesy between you, now, as to whether you are going to furnish the other person a copy.

Mr. Maiden: Well, your Honor, I object to this journal going into evidence with the right of counsel to supply photostatic copies of certain pages without the understanding that I likewise will have the right to submit photostats of any of the entries in the journal that I think might be pertinent in the case.

Mr. Webster: That is perfectly all right.

The Court: Of course, I will give you both that privilege if I give it to either one of you. The ledger is admitted into evidence. Both sides will be given permission to substitute a photostatic copy for any pages that have been referred to in evidence and which either counsel sees fit. [182] It will be admitted into evidence as Exhibit No. 31.

(Testimony of Elias J. Aye.)

(The document above-referred to was received in evidence and marked Petitioner's Exhibit No. 31.)

Mr. Webster: No further questions, your Honor.

Cross Examination

By Mr. Maiden:

Q. Mr. Aye, who was it who asked you to take over the corporation's books?

A. Mr. Carpenter.

Q. Mr. Carpenter? A. Yes.

Q. When was that?

A. Oh, it was early in 1942. I don't remember the exact date.

Q. Did you immediately go out to the plant and go over the books?

A. No, I couldn't do it right at the time.

Q. Well, what was the occasion for your going out there when you did, in April or May?

A. Well, it was just like another job, I had to go out and do it, I was asked to do it.

Q. What did you go out there to do?

A. To see that the books were properly set up and that they were properly being kept.

Q. Did Mr. Carpenter indicate to you that he didn't [230] know whether the books were being kept properly? A. No.

Q. He didn't tell you, then, that he thought the books had been kept improperly and he wanted you to go out and straighten them out?

(Testimony of Elias J. Aye.)

A. He wanted me to go out and take charge.

Q. Well, Mr. Carpenter had a bookkeeper, didn't he, keeping his books currently?

A. He had had a bookkeeper for a great many years whom I never met, this Mrs. Jennings that he spoke of. He had a new bookkeeper when I got there.

Q. Was that a man or a woman?

A. That was a woman. She defaulted on some of her funds.

Q. Which bookkeeper defaulted?

A. The new one.

Q. The new one? A. Yes.

Q. Do you know when the new one was employed?

A. She was there when I went out there.

Q. She wasn't the bookkeeper that had been there at the end of 1941? A. No.

Q. Did you ever contact the bookkeeper who kept the books in 1941? [231]

A. No, I have never seen her.

Q. You have never seen her. Well, when you got out there to the plant, what did you do first?

A. I tried to find out what they had on their books. You usually start in with the general ledger.

Q. Is that what you did in this case?

A. I imagine so.

Q. Then, after you went through the general ledger, did you see anything wrong with the general ledger?

A. Yes. They didn't have any notes payable.

(Testimony of Elias J. Aye.)

Q. Well, had you previously been advised that there were some notes payable that had been issued?

A. Yes, I knew about those because, as I said before, Mr. Simon and Mr. Lyman had been clients of mine for many years, and I knew that they had some notes from this corporation.

Q. Well, how did you happen to know that they had some notes from this corporation, Mr. Aye? A. They had the notes.

Q. Well, what was the occasion for their showing you the notes?

A. I also saw all of those things. If they brought stock, I saw it.

Q. Well, before you went out to the plant?

A. No.

Q. I thought I understood you to say that Mr. Carpenter [232] asked you to go out and take charge of the books and go over the books.

A. He did. I think it was Mr. Simon's idea, but, of course, Mr. Carpenter had to ask him before I could.

Q. But before you went out there, they told you they had notes of the corporation?

A. Yes, I knew that when I got there. I knew they had stock in the corporation, I saw that their records were kept.

Q. Oh, you kept Mr. Simon's and Mr. Lyman's records, is that right?

A. I looked at them, yes.

Q. For their personal returns or corporation

(Testimony of Elias J. Aye.)

returns? A. Both.

Q. Both. For some of Mr. Simon's corporations, is that right? A. All of them.

Q. You had seen some notes that Mr. Simon and Mr. Lyman had, as well as some stock?

A. Yes.

Q. In this particular corporation?

A. That is true.

Q. Now, did they tell you that those notes hadn't been set up on the books?

A. They didn't know that. [233]

Q. They didn't know that. I believe you stated on direct examination that Mr. Carpenter likewise told you that he had some notes, is that right?

A. Well, I knew about the situation. I don't remember whether it was Mr. Carpenter that told me or Mr. Simon told me.

Q. Well, I believe you did state on cross examination that when you went out there and found that there weren't any notes on the books, that you went to Mr. Carpenter and Mr. Simon both and asked them about it, is that right?

A. That is correct.

Q. And that you asked them whether this was the way it should be or whether it should be set up with the notes as loans, and that they told you that the books had been set up wrong?

A. I don't believe I said that.

Q. Well, just what did you say?

Mr. Shearer: I object——

Mr. Maiden: Just a minute, I am asking what he did say.

(Testimony of Elias J. Aye.)

The Witness: I reported to them that the books didn't show any notes.

By Mr. Maiden:

Q. Well, I believe you stated something about asking them if that was correct, and they said that was wrong. [234]

A. I don't think I said that.

Q. You talked to Mr. Carpenter about it?

A. Yes.

Q. You explained to Mr. Carpenter that the notes didn't show upon the books?

A. Yes.

Q. And explained to him that the entire advancement had been set up to capital stock?

A. Had been set up as advances by stockholders.

Q. Well, had been set up as chargeable to capital stock to be issued? A. That is right.

Q. Now, Mr. Aye, you are not undertaking to tell this Court that those notes were in fact bona fide loans rather than investments, are you? I mean, you have no personal knowledge of that, yourself?

Mr. Webster: If your Honor please, I request the question be read.

The Court: Read the question.

(The question was read.)

The Witness: Yes, I have personal knowledge of that. I was present when they talked about it, when they discussed it.

(Testimony of Elias J. Aye.)

By Mr. Maiden:

Q. When was that, Mr. Aye? [235]

A. Oh, that was when they were going into this deal.

Q. You mean you were present when these men discussed the formation of this corporation?

A. Yes.

Q. Did you hear them discuss the capital structure of this corporation? A. Yes.

Q. Did you participate in the discussions?

A. Well, I never had much to say, but they used to have me come in and sit in the office a lot of times.

Q. You weren't working for this corporation, though? A. I was working for Mr. Simon.

Q. Working for Mr. Simon. Did you hear him say—explain why they wanted to take notes for part of the advancement rather than take it all in stock?

A. Yes, as they said here, they wanted to be——

Q. I don't care what they said here. I want to know what they said in this conference that you attended with them.

A. Well, they said they wanted to take part of it in stock and part in notes.

Q. Well, did they say why?

A. Yes, they could get the money back for the notes.

Q. Have you been present during the testimony of Mr. Carpenter and Mr. Simon?

A. Yes. [236]

(Testimony of Elias J. Aye.)

Q. You heard them testify in this case?

A. Yes, I did.

Q. Did you hear them say anything about the tax benefit of this arrangement?

A. Yes, I think they discussed that, too. Of course, the tax benefit is apparent.

Q. Did you request Mr. Carpenter to read the amended return, which you say you prepared for 1941?

A. Yes, I gave it to him, but he didn't read it.

Q. Is it customary for you, in your preparation of tax returns, to request that the client read the return and discuss the return with you?

A. Yes. Some of them do, but most of them don't.

Q. Now, Mr. Aye, you state that you prepared an amended return for 1941, and you stated that you filed that return, is that right? A. Yes.

Q. Did you personally file it?

A. I think it was mailed from the office.

Q. Do you have personal knowledge of the fact that that return was mailed from your office?

A. Well, that would be the ordinary course of business.

Q. Well, I am asking you now, do you know in this case as a matter of fact that that return was mailed to the Collector of Internal Revenue?

A. I didn't mail it myself, I don't imagine.

Q. So you don't know as an actual fact whether it was mailed?

A. At the same time we made out a return to

(Testimony of Elias J. Aye.)

the State Franchise Tax Commissioner; we got a letter back about that one.

Q. Did you get a letter back about the filing of an amended 1941 return from the Federal Government? A. No.

Q. All you know is that you prepared this return, this amended return?

A. Yes, prepared it, and I know that it was filed.

Q. Well, now, just tell me how you know it was filed if you didn't file it physically and you didn't mail it?

A. Well, it is the ordinary procedure, it is the ordinary course of business.

Q. Well, you are just assuming that you followed the ordinary course of business in this case?

A. That is correct.

Q. Did you prepare any claim for refund?

A. Yes, I believe I did.

Q. When did you prepare those?

A. I think it was filed at the same time.

Q. The same time? A. Yes. [238]

Q. Are you sure of that?

A. I should think that an 843 would be filed at the same time, yes.

Q. In filing the returns through the mail with the Collector of Internal Revenue, did you usually accompany the return by a letter of transmittal?

A. No, sir.

Q. What did you do, just put them in an envelope? A. Yes.

(Testimony of Elias J. Aye.)

Q. That is always your practice?

A. Well, in the rush season, I will send them up with a list and get a receipt for it, when they are throwing them in baskets and on the floor, and places like that, but in an odd return like this, filed by itself, I just mail it to them.

Q. You didn't accompany it with any letter of transmittal? A. I don't think so.

Q. As a matter of fact, I believe you stated that you didn't put the return in an envelope and mail it, address it—

The Court: Haven't we gone over this often enough? This man has said in effect a long time ago—it has been quite obvious—that he didn't know positively, and he said he relies upon his course of business. Let's not run this thing threadbare.

Mr. Maiden: Yes, sir. [239]

By Mr. Maiden:

Q. Now, Mr. Aye, all the changes that you made on the books there in the spring of 1942 were changes made to reflect or to show the advancements made by the organizers and stockholders as an investment of \$30,000.00 and loans of \$25,000.00; is that correct? A. Yes.

Q. You opened such other entries in the books as were required by that change? A. Yes.

Mr. Maiden: I believe that is all, if the Court please.

The Court: Is there anything further of this witness?

Mr. Webster: Nothing further, your Honor.

The Court: Mr. Aye, I have been wondering

(Testimony of Elias J. Aye.)

why, since you represented, as I understand you to say, Mr. Simon and Mr. Carpenter in 1941 in their personal income tax matters, and you being a tax man, I am wondering why you were not used originally to set this matter up rather than Colonel Whittaker.

The Witness: I think you misunderstood me. I said that I was—I made the returns for Mr. Simon and Mr. Lyman, who is Mr. Simon's brother.

The Court: Not for Mr. Carpenter? [240]

The Witness: Not for Mr. Carpenter. Mr. Carpenter was in charge of this corporation, so he had this man do it.

The Court: I see. Mr. Carpenter was in charge, and he had his own man do it, and you were not called upon to do this work in 1941?

The Witness: Yes, sir.

The Court: That is, the corporate work.

The Witness: The corporate work I had nothing to do with until 1942.

The Court: That is all I want to ask.

Mr. Webster If your Honor please, I have overlooked that Petitioner's Exhibits 29 and 30 for identification have not been introduced, and I offer them in evidence at this time.

The Court: Petitioner's Exhibits Nos. 29 and 30 are admitted in evidence.

(The documents heretofore marked Petitioner's Exhibits Nos. 29 and 30 were received in evidence.)

Mr. Webster: That is all, your Honor.

The Court: Is this witness being excused by both sides?

Mr. Webster: Yes, your Honor.

(Witness excused.)

The Court: Do you have any further evidence for the Petitioner? [241]

Mr. Webster: Yes, your Honor.

The Court: We will be recessed at this time for ten minutes.

(Short recess taken.)

The Court: Proceed.

Mr. Webster: Mr. Tompkins.

Whereupon,

CHARLES B. TOMPKINS

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you tell us your name, please?

The Witness: Charles B. Tompkins.

Direct Examination

By Mr. Webster:

Q. Mr. Tompkins, what is your occupation?

A. I am a certified public accountant.

Q. How long have you been practicing in that capacity? A. About thirty-odd years.

Q. You are admitted to practice here in California? A. Yes, since 1928.

Q. There has been testimony to the effect that you worked for Mr. Aye, is that correct?

A. I did.

(Testimony of Charles B. Tompkins.)

Q. Would you state the dates? [242]

A. Well, approximately the early part of 1942 until about the latter part of 1946.

Q. In the latter part of 1946, as I understand it, Mr. Aye retired; is that right?

A. That is right.

Q. Did you have anything to do with the books and ledger accounts of Wilshire and Western Sandwiches?

A. Yes. Mr. Aye called me into that in about August of 1942. From then on I have had pretty general charge of those books.

Q. Mr. Tompkins, I call your attention to a ledger account appearing under the tab "Liabilities," entitled "Interest Payable Accrued," and I ask you whether you can identify the handwriting.

A. I think everything on that page—yes, everything on that page is my handwriting.

Q. Would you briefly explain to the Court the significance of the entries found on that page?

A. Well, when Mr. Aye was making out the tax return for 1942, the question of interest on the notes advanced by the stockholders came up, and it was found then that no interest had been accrued, so I made that first entry accruing the interest up to the end of December, 1942.

Q. In what amount?

A. That was in the amount of \$1,687.50. [243]

Q. There is a posting reference to J-14; would you—

A. That is the journal entry on which the item

(Testimony of Charles B. Tompkins.)

is set up and charged to the expense account at the bottom of the page.

Q. Can you identify the handwriting?

A. Yes, I wrote it.

Q. Would you read to the Court the contents of that entry?

A. The entry charges \$1,500 to interest expense of 1942, under \$187.50 against the earned surplus, where the interest accrued in 1941 from the time of the notes up to the end of that year, and then the liability is set up as interest payable accrued for \$1,687.50.

Q. Can you remember when you made this entry?

A. I think it must have been along in February, or possibly March, of 1943.

Q. With respect to the first entry on the ledger account entitled "Interest Payable Accrued," when did you make that entry?

A. That was made at the same time. It was dated back to December 31st, because we were closing the books for the year 1942.

Q. Would you kindly describe the succeeding entries in general terms which you find on that page?

A. The next entry was made at the end of March, 1943, [244] and covered the accrual of three months' interest, and after that the entries were made monthly and accrued the interest of the current month clear up to the time the notes were finally paid.

(Testimony of Charles B. Tompkins.)

Q. Can you indicate whether this interest payable accrued account reflects the payment of any interest?

A. Yes. In November of 1943, interest amounting to \$3,055.86 was paid to the noteholders, and again in March of 1945, \$682.10 was paid, and that was all the interest that was paid on those notes.

Q. Mr. Tompkins, I note that the posting reference, with respect to virtually all of the succeeding entries that follow the first entry on the interest payable accrued account, refer to SJ-2. Would you kindly explain the significance of that posting reference?

A. "SJ" was short for standing journal, and the standing journal covered the entries that were made every month, and instead of having to write them each time, just the amounts only were written in columns spread across the page.

Q. Were these standing journal entries in your own handwriting?

A. Some were in my handwriting, and some are in the bookkeeper's handwriting.

Q. Mr. Tompkins, I refer you now to the ledger account page which bears at the top the title "Interest [245] Expense," which appears under the tab "Expenses" in the general ledger of Wilshire and Western. Will you kindly explain briefly to the Court what you find on that page?

A. That was the expense charge for interest that was offset by the liability for the accrual, and each year that was closed off into operating expenses.

(Testimony of Charles B. Tompkins.)

Q. There is a posting reference with respect to the first item appearing on that page to J-14?

A. That entry was for the \$1,500 accrued for the year 1942.

Q. That is the same reference as the—

A. Same reference as the accrual of \$1,687.50 referred to just now, except that only part of it was charged to the current year's expense.

Q. Mr. Tompkins, a question has been raised in the course of this trial with respect to the date upon which the contents of pages 4, 5, and 6 under the tab "Journal" were actually made. I believe you were in court at the time that Mr. Aye testified that those pages were in his own handwriting, is that correct?

A. Yes, that is correct.

Q. J-7 is the page following J-6. Could you recognize the handwriting on that page?

A. That is my handwriting.

Q. The first entry bears what date? [246]

A. June 30, 1942.

Q. Do you recollect making that entry?

A. Yes, I made the entry; it would be sometime later than that.

Q. How much later?

A. That I can't tell you exactly. Probably in the next two or three months, because I didn't go in there until August, so it must have been that much later. [247]

Q. Do you recollect seeing the preceding pages to which I have made reference, J-4, 5 and 6?

A. They have been in the ledger since I saw it.

(Testimony of Charles B. Tompkins.)

Q. Which was in August of 1942?

A. On or thereabouts, yes.

Q. Did you make any use of the correcting entries which are contained in J-4, 5 and 6, when you arrived in August, 1942?

A. Oh, yes, I have embodied them in some working papers of mine where I was trying to bring the books down to date, whatever that date was at the time. I think I tried to get a trial balance as of June the 30th when I made this first entry in my own handwriting.

Q. You employed some of the figures of Mr. Aye?

A. Oh, yes. These all had to be put on to get a new balance sheet as of December the 31st.

Q. I call your attention to the ledger account entitled "Advances by Stockholders", which bears the number 203, and which appears under the tab "Liabilities" in the general ledger of Wilshire and Western. I ask you whether any handwriting on that page is familiar to you.

A. All of it is.

Q. Is any of it yours?

A. Yes. The last three items showing payments of ninety-nine hundred odd, \$10,000 and \$5,000—in other [248] words, the payment of the \$25,000 of notes originally set up is in my handwriting, and I know the handwriting of the previous entry of \$10,000.

Q. Whose writing was that?

A. That was a bookkeeper that stayed there for a short time named Beverly Priest.

(Testimony of Charles B. Tompkins.)

Q. Do you know the person who wrote the preceding two, which would make it the first and second entries appearing on that page?

A. Yes. That is Mr. Aye's handwriting.

Q. At the time that you made your first entry in your own handwriting, which is the date April 30, 1943, were these preceding entries on that page?

A. They were.

Q. At what time did you make the entry which is dated April 30, 1943?

A. Probably sometime in May. It is generally about the latter third of the month before the books are ready to close, so I should guess that it would be somewhere around May the 20th of 1943 that I made that entry.

Q. Mr. Tompkins, would you state whether you are familiar with the cash and accrual method of keeping books?

A. Yes, indeed.

Q. Will you state what method was used in the keeping of these books? [249]

A. Well, both, but largely cash. All sales were made for cash and all bills were paid for each month that could be paid before the books were closed for that month. In other words, the books were kept open until perhaps the 10th or 15th of the following month, and the entries were charged back as of the previous month to get all the payments made, so no accounts payable appear on the books except as between interlocking companies; that is any one of the other three companies that Mr. Carpenter operated might owe Wilshire and Western or be owed by Wilshire and Western.

(Testimony of Charles B. Tompkins.)

Q. How do you explain the significance of the interest payable accrued account?

A. That was one of the accruals that we had to set up because that wasn't paid every month. That was paid when Mr. Carpenter ordered it to be paid.

Q. Do you know on what basis the tax returns of Wilshire and Western were prepared?

A. I believe it is on an accrual basis. I prepared them. They are there.

Q. I show you now the 1942 and 1943 income tax returns of Wilshire and Western, and ask you if you can state upon what method these returns were prepared.

A. Question 10 answers it. It says that the return is made on the basis of accruals.

Q. You are looking now at the 1943? [250]

A. I am looking at the 1943 return, and the 1942 return—the same answer to the same question.

Mr. Webster: That is all, your Honor.

Cross Examination

By Mr. Maiden:

Q. Mr. Tompkins, the entries that you made in the books when you went there in August 1942 were pursuant to instructions from Mr. Aye?

A. I think so, yes.

Q. I believe you stated that you set up interest accrual accounts for 1942, that you actually set them up sometime in 1943?

A. Just as we were closing the books for 1942, yes.

Mr. Maiden: No further questions, if the Court please.

The Court: You are excused. Call your next witness.

(Witness excused.)

Mr. Webster: That is all for the Petitioner, your Honor. However, if your Honor please, at the opening of this case yesterday I made a request for the privilege to make a motion at the end of Petitioner's case with respect to the bringing on of Mr. Odell as a witness. Mr. Odell was the attorney who was active in the formation of Wilshire and Western and is still active in its legal affairs. I [251] stated then that the main purpose for desiring to have Mr. Odell appear was that it was understood some question was raised as to whether there was or was not any back dating on the issuance of notes and of stock, whether there was possibly any back dating of minutes.

Furthermore, an additional point was whether the letter of December 5, 1941, which has been admitted in evidence was in fact prepared and dispatched on that date.

Mr. Odell right now has a 103 fever, and we felt that we might be able to get along without him. However, at this time I should like to ask of government counsel whether he is in a position to state whether any contention with respect to the back dating of the issuance of the notes and of the stock certificates and of the delivery thereof and of the making and execution of signing of the minutes of November 13, 1941, meeting will be subject to attack in brief?

Mr. Maiden: Your Honor, that is an unfair question at this time. I am unable to answer it, and I will not be able to answer it until I read the record.

Mr. Webster: In that case, your Honor, I should like to make the request and motion that Mr. Odell be permitted to testify sometime the latter part of the next week if it fits the Court's calendar. I spoke to Mr. Odell last evening and he told me that his doctor anticipated that [252] Penicillin treatments that he is receiving now will be able to get him better by the end of next week.

Mr. Maiden: I will say this, if the Court please, in order to accommodate the situation, that if Mr. Odell is not able at the end of this calendar to come here and testify, I will agree that the case may be held up for the receipt of his deposition.

The Court: I was going to suggest that very thing, and I not infrequently allow depositions to be taken after the case has been tried to pick up some remnant of the case. We will hear Mr. Odell this next week if we can work it in, unless, of course, if this docket should break as they sometimes do before he is able to come in, why, we will simply have to take a deposition. I don't see how we can set a time, not only on account of his condition, but on account of this docket. I hardly see how we can set a date exactly. Now, I would think that if he wants to take his testimony, and, of course, sometimes an attorney prefers testimony to a deposition—they are never quite the same perhaps—that it would be preferable to get that taken

before the end of Tuesday, but, of course, he may not be in condition to do it by that time. After Tuesday this docket it seems to me, unless there are some breaks in it, it is going to be pretty heavy, and it might cause us to take the deposition instead. We will get the testimony by working it in on this docket or [253] by the deposition.

Mr. Webster: That will be satisfactory.

I should also like to make two motions at the conclusion; one, is to amend 5-A of the petition to conform to the proof.

The Court: In what respect?

Mr. Webster: Your Honor, the petition states that the original plan was to issue \$30,000 of capital stock, and that uncertainty existed at that time as to how much additional would be required in the form of loans. This statement of fact is inaccurate, as has been brought up by the evidence, and I would request permission of the Court to amend the pleadings to conform to the proof.

The Court: Is there any objection?

Mr. Maiden: No objection, if the Court please.

The Court: Very well, you will be permitted within 10 days to file your amendment to Paragraph 5-A in writing. Now, that means that it will have to be written and filed.

Mr. Webster: Yes, your Honor.

Further, I should like to make the motion that Petitioner be permitted to withdraw, I believe, all exhibits with the privilege of substituting photo-stats thereof.

The Court: Well now, counsel, we try these

cases all over the country. We can't leave our records all over [254] the United States and Hawaii, otherwise the taxpayers of this country would be in a rather bad fix to try these cases. If you have particular exhibits that you really need to file a motion, why, you determine which particular exhibits you need to substitute, and then I will consider it, but I am not going to grant a blanket motion to withdraw any exhibits.

Mr. Webster: I can specifically limit myself to the stock book, which I believe we will have use for.

The Court: You will be permitted to withdraw the stock book unless there is some objection.

Is there any objection?

Mr. Maiden: No objection.

The Court: It is not within the control of the opposing party, of course, either way, but sometimes there are exhibits that one of the other parties might not want to substitute because of the authenticity of a signature or something. There being no objection—

Mr. Webster: I am sorry, your Honor. If your Honor please, you have already given permission to withdraw certain of the pages in the general ledger.

The Court: Yes, that has been done. Permission will be given to withdraw the stock book.

The Clerk: That is Exhibit No. 17, if the Court please.

The Court: Exhibit No. 17, and you will be permitted [255] to substitute a photostatic copy.

Now, is the entire stock book in evidence? I mean is it all pertinent, or is it only certain portions?

Mr. Webster: Your Honor, the first eight stubs, I believe, and any certificates which are attached to those stubs are the only portions of the stock book which are in evidence. It is either 8 or 9 stubs, I am not sure which.

The Court: Well, permission is given to substitute the stock book.

Now, this could be attended to just as well before the end of the case, but it might as well be attended to now. A while ago evidence was offered to impeach the testimony of the Witness Carpenter. Objection was made in such terms as I didn't think was a good objection. You simply objected because it wasn't within the issues. No objection was made because there was not then offered a conviction. Then the question went to an indictment. Later it was brought out that he pleaded *nolo contendere* and paid a fine——

Mr. Webster: If your Honor please, may I make this request, that the court room be cleared if we are going into this matter?

The Court: Well, all I am going to say is that instead of sustaining that objection—there will be nothing further stated that will be prejudicial to the minds of anyone—instead of sustaining that objection, I am withdrawing [256] that ruling. I still think it is good, but in the interest of absolute fairness, I am going to withdraw that ruling and withhold my ruling and let you gentlemen brief the question as to whether the facts—and I won't make

any further reference as to what they are—do constitute such as to impeach veracity or credibility. I am inclined to think that probably they do not, but it is rather close.

Mr. Shearer: Will your Honor permit on that a motion to strike in the brief in the event——

The Court: Well, I don't think you need a motion to strike. I will consider that as an effect of credibility or not, as I am convinced by your briefs, withholding my ruling accordingly instead of overruling the objection as I did at that time.

Mr. Shearer: I was thinking of the record, your Honor.

The Court: Very well, for the sake of the looks of the record, if I should decide not to consider it, I will consider a motion to strike in your briefs, yes.

Mr. Shearer: Thank you.

Very well, the Petitioner has rested with the exception announced to the taking of the testimony of another witness, either in person or by deposition.

Mr. Maiden: I have one witness to put on, if the Court please. [257]

The Court: Put on your witness.

Whereupon,

FRED WIGNALL

called as a witness for and on behalf of the Respondent, having been first duly sworn, was examined and testified as follows:

The Clerk: Tell us your name, please.

The Witness: Fred Wignall.

(Testimony of Fred Wignall.)

Direct Examination

By Mr. Maiden:

Q. Mr. Wignall, by whom are you employed?

A. The Collector of Internal Revenue.

Q. In what capacity?

A. Chief of the Income Tax Accounts.

Q. As Chief of the Income Tax Account Section, what are your duties, briefly?

A. I have charge of all the records, income tax returns and claims, bookkeeping, listing of all returns.

Q. Mr. Wignall, have you appeared here at my request? A. Yes, sir.

Q. Did you make a search of your records to determine whether or not your records showed the filing of an amended 1941 income tax return for Wilshire and Western, Inc.? A. Yes, sir.

Q. What do your records show in that respect?

A. The records failed to disclose the filing of any amended return for the Wilshire and Western Sandwich Corporation for the year 1941.

Q. Did you make a search to determine whether or not your records disclosed the filing of any claims for refund with respect to the year 1941?

A. I did, sir.

Q. What do your records disclose?

A. The records show that a claim was filed for the year 1941 on January 18, 1945.

Q. Mr. Wignall, you have charge of recording the filing of income tax returns? A. Yes, sir.

(Testimony of Fred Wignall.)

Q. Just when and how are recordings made in the Collector's office upon the filing of returns?

A. Will you be specific? In what type of returns are you interested?

Q. Well, an amended return, increasing or decreasing the amount of the tax liability shown on the original return.

A. They are both handled differently. An additional tax amended return showing additional tax is received by our office, depending whether there was money on the return or not. It goes to the cashier and is sent down to my section. We list the return. A bill is issued if necessary, and returns are forwarded to the Bureau. [259]

If the return is an amended return showing a decrease in tax liability, it goes into the claims section and there a card record is made of the return. The return is then forwarded to the Bureau with a letter of transmittal to be associated with the original return. I am speaking now of corporation returns.

Q. Have you examined all of the card records in all the sections through which the return would pass to determine whether or not a 1941 amended return was filed by this corporation?

A. Yes, I have. I have checked the records for an addition in tax and for a decrease in tax. I can find no record of either one being filed.

Q. Did you check the cards upon which the filing of the return would be listed if one was filed?

A. I did, sir.

(Testimony of Fred Wignall.)

Q. You found no record?

A. No, I did not.

Mr. Maiden: No further questions.

The Court: Cross examine.

Cross Examination

By Mr. Webster:

Q. Have you ever heard of a taxpayer claiming that he filed an amended return or an original return which you didn't find any record of in your office? [260]

A. Yes, sir.

Mr. Webster: That is all, your Honor.

The Court: Any further questions?

Mr. Maiden: No further questions, your Honor.

By the Court:

Q. I want to get some idea, Mr. Witness, as to how often that happens; that is, directing your thoughts to the last question. I have to consider probabilities on this thing. How often do you lose a filed return or have complaint that one has been filed which you find no record of?

A. I wouldn't be able to accurately answer that question. We have had about——

Q. I don't expect you to answer it accurately, of course. I want you to give me the best idea you can.

A. I don't know how to really answer it, sir.

Q. I appreciate it is a hard question, sir. How many returns go through your office in a year?

A. Approximately 3,000,000.

Q. How many in a year would you find missing

(Testimony of Fred Wignall.)

or returns that are claimed to have been filed and that you have no record of?

A. I really have no way of answering it, because all the inquiries of lost returns don't come to my attention.

Q. How many come to your attention in the course of a year?

A. Well, I would say approximately—and it is an [261] approximation—100.

Q. 100 out of 3,000,000?

A. That is right. That is an approximation, sir.

The Court: That is all I wanted to ask.

Any further questions of this witness?

Mr. Webster: No, your Honor.

Mr. Maiden: No further questions.

The Court: You are excused.

(Witness excused.)

Mr. Maiden: Respondent rests, if the Court please.

The Court: Respondent rests. Does the Petitioner have anything further at this time?

Mr. Webster: No, your Honor.

The Court: Now, in case you gentlemen can't get the testimony, or, we will say that we can't get the testimony of this Witness Odell this next week, then you will be left to take a deposition. That makes it hard to set the time for briefs. I suggest that as soon as you find out whether you are going to offer this testimony in person or find out that you are not, that you contact opposing counsel and see me and then we will set the time for filing briefs

according to how the matter of the other testimony is going to be taken.

Mr. Webster: Very well.

(Whereupon, at 4:30 o'clock p.m., Thursday, December 4, 1947, the hearing in the above-entitled matter was adjourned as above noted.)

[Endorsed]: T.C.U.S. Filed Dec. 19, 1947. [262]

Los Angeles, Dec. 12, 1947

PROCEEDINGS

The Clerk: 10638, Wilshire and Western Sandwiches, Incorporated.

Mr. Crouter: E. C. Crouter responding for respondent in that case, for R. E. Maiden, Jr., attorney of record.

The Clerk: Mr. Webster for petitioner.

The Court: Now, do we have anything in this sandwich case excepting the deposition to take?

Mr. Crouter: Yes, your Honor. I believe Counsel wants to substitute exhibits, which he will explain; and it is agreeable to respondent.

Mr. Webster: If your Honor please, you will recall that certain exhibits were withdrawn for the purpose of making photostats. I have here the photostats of ledger accounts of Wilshire and Western Sandwiches, which have been gone over by Mr. Maiden and by the technical assistant in the technical staff's office. The ledger book itself had been marked Petitioner's Exhibit No. 31, on the inside

of the cover, but no mark was placed on the pages themselves, which here are photostated, and I offer these, I understand, without any objection on the part of Mr. Crouter.

Mr. Crouter: That is correct. No objection by respondent.

Mr. Webster: As petitioner exhibits substituted for the Exhibit No. 31 originally submitted. [265]

The Court: Very well. Mr. Clerk you may substitute the matter referred to in lieu of Exhibit No. 31.

Mr. Webster: If your Honor please, I have a suggestion to offer, that each of these pages be designated by an alphabetical letter following the 31, for convenience in briefs.

The Court: That is an excellent suggestion. We often do that. Will you just take the Exhibit and number the pages themselves A, B and C.

The Clerk: I have marked the first page Exhibit 31, the second page will be 31-A, your Honor.

The Court: 31-A, B and C, just mark them.

Mr. Webster: Now, your Honor, one other exhibit which was withdrawn was a stock book, for the purpose of taking photostats of pages contained therein. It appears that the revenue stamps which were contained in the original stock book had a legend on their face which did not come out in the photostat. I discussed this matter with Mr. Maiden and we agreed that we might place a sheet of paper in front of this exhibit indicating the contents of the legend which was written on the face of the revenue stamps in the stock stuff.

The Court: Very well. I take it that the contents that have been attached is a matter of stipulation?

Mr. Crouter: Yes, that offer is agreeable to respondent. [266]

The Court: What exhibit is that?

Mr. Webster: That is Exhibit 17, if your Honor please.

The Court: This matter will be substituted for Exhibit 17, and you will also indicate the page numbers A, B, C and D on that one, if you have several sheets.

Mr. Webster: If your Honor please, I don't think it is necessary in that particular case, because the certificates are numbered.

The Court: Very well.

Mr. Webster: At the conclusion of the petitioner's case a motion was made to amend the petition to conform to the proof, and I have here one original and four conformed copies of that motion.

The Court: Any objection?

Mr. Crouter: I have been advised of this, but I have not had a chance to read it. If the Court please, there is no objection to making the motion to amend or granting the motion, and respondent would merely like to have a period of say 10 days within which to file an answer if deemed necessary. It may be that none will be necessary.

The Court: The motion is granted and the amendment is filed. Respondent is allowed 15 days from this date within which to file answer, if he wishes.

Mr. Webster: Your Honor, with respect to the testimony [267] of Mr. Odell, I have been in contact with him and found out that it is impossible for him to appear before the Court. He won't be ready for any type of legal work until the latter part of next week, and accordingly, I request that permission be granted to take his deposition for inclusion in the testimony in this case.

Mr. Crouter: That is agreeable to respondent, at a convenient time, of course.

The Court: If that be stipulated by the two of you in accordance with our rule 45(e), I believe it is and duly set forth, I will say now that your application will be granted to take the deposition, and deposition ordered taken prior to January 1, 1948. That is all we have, is it? Except the setting of briefs.

Mr. Webster: Yes, your Honor.

The Court: Very well. Briefs will be simultaneous briefs to be filed by February 1, 1948, reply briefs by February 25, 1948.

The Clerk: The record shows, if your Honor please, that a copy of the motion to amend the petition to conform to the proof is now being served on the parties litigant.

The Court: I believe that disposes of that, doesn't it?

Mr. Webster: Yes, your Honor. Thank you.

(Whereupon at 11:00 o'clock a.m. December 12, 1947, the hearing in the above entitled matter was closed.)

[Endorsed]: T.C.U.S. Filed July 8, 1948. [268]

The Tax Court of the United States

Docket No. 10638

WILSHIRE AND WESTERN SANDWICHES,
INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DEPOSITION OF ROBERT A. ODELL

Deposition of Robert A. Odell, taken on behalf of the Petitioner, at Room 1011, Van Nuys Building, 210 West Seventh Street, Los Angeles, California, on Monday, December 22, 1947, at 4:00 o'clock p.m., before Virginia K. Pickering, a Notary Public within and for the County of Los Angeles and State of California, pursuant to the annexed stipulation to take deposition.

Appearances of counsel: Martin H. Webster, Esq., 320 Bartlett Building, 215 West Seventh Street, Los Angeles, California, appearing on behalf of the Petitioner. Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, of counsel: R. E. Maiden, Jr., Attorneys for Respondent. [271]

ROBERT A. ODELL

called as a witness on behalf of the Petitioner, having been first duly sworn, deposed and testified as follows:

(Deposition of Robert A. Odell.)

Direct Examination

By Mr. Webster:

Q. Would you kindly state your name?

A. Robert A. Odell.

Q. And your occupation?

A. Attorney at law.

Q. How long have you been in the practice of law?

A. I was admitted in June, 1905, and I have been practicing in Los Angeles since January 1, 1906.

Q. What sort of practice have you had?

A. Well, general practice, all phases of the law, without many criminal cases.

Q. Have you heard of Wilshire and Western Sandwiches, Inc.?

A. Yes.

Q. Would you identify them?

A. Well, it is a corporation.

Q. They are your clients?

A. Yes, they have been my clients.

Q. How long have they been your clients?

A. Well, since the incorporation of the company.

Q. Are they your clients now?

A. Well, yes, excepting that I don't want to make [272] any client's disclosures. There has been some change in the ownership, and I may not be their attorney when that is fully effected, but for all purposes, I imagine, connected with this matter, I have been attorney for them. That is, our firm has been, Tanner, Odell & Taft.

(Deposition of Robert A. Odell.)

Q. You say you have been the attorney of Wilshire and Western Sandwiches, Inc., since its incorporation. Were you active in the incorporation of that?

A. I did the legal work in connection with the corporation, application for permit and matters of that sort; such matters as they have conferred with me about.

Q. Mr. Odell, I will show you Petitioner's Exhibit 12 in this matter, being minutes of a meeting bearing date of November 13, 1941. I ask you whether you have seen those minutes before.

A. Yes.

Q. Would you kindly state all you know in connection with those minutes?

A. Well, I prepared these minutes and they are a correct statement of what took place at the meeting on that day, November 13, 1941.

Q. There was a meeting on that date?

A. Yes; 4:00 o'clock in the afternoon.

Q. Would you kindly tell how it is you know there was a meeting on that date?

A. Well, I prepared these minutes, and the minutes [273] recite it took place at that time. My journal entry, kept in the regular course of business, shows a meeting at that time. I recall the attendance at the meeting and the supervision of the holding of the meeting, and seeing to it that these things took place which are recited in the minutes.

Q. Would you describe more fully the manner in which the meeting was held?

(Deposition of Robert A. Odell.)

A. It was held at this room, 307 Transamerica Building, 649 South Olive Street, in Los Angeles, which is the office where Mr. Simon, one of the incorporators, had his office.

Q. Who were in attendance at that meeting?

A. These persons whose names are given in the minutes as having been present at that time.

Q. Would you state who they were?

A. They were Harry B. Carpenter, William H. Simon, Mike Lyman, and M. A. McDonnell. Mr. Jobson signed a consent to the meeting. He was one of the original incorporators, also. I don't think he attended.

Q. Would you kindly state exactly what you did at that time?

A. Well, I had the meeting properly called to order and my recollection is that I read these minutes and had the action taken by the vote of the board for each one of these actions as they show here on the minutes.

Q. Is that your customary procedure or is it an [274] exceptional method of handling a corporate meeting?

A. That is my customary procedure for organization meetings, and any other meeting. If for any reason they don't take the particular action, the minutes are changed before they are signed and put in the minute book.

Q. You have these minutes prepared before the meeting? A. Yes.

Q. What information did you have with respect

(Deposition of Robert A. Odell.)

to the subject matter of this particular meeting at the time that you prepared these minutes which, as you say, was before the meeting?

A. Well, that covers a good deal of territory. Mr. Carpenter advised with me from time to time above the matter involved here, and I had the information from which the minutes were prepared, on which the action was taken, from his statements and conferences with him. I may have conferred with the other gentlemen from time to time, but not to any great extent.

Q. With particular respect to the contents of these minutes, can you recall when you received the information which is set forth in those minutes? A. Well, I can't tell you exactly.

Q. Can you approximate how much before the actual meeting date you learned of the proposed action which was to be taken at that meeting? That is, just an approximate date.

A. Well, referring to our firm journal, I find an [275] entry of October 9th, "Wilshire and Western Sandwiches, Inc., drafting resolution, minutes, etc."

Then, on October 10th—and this is 1941—"Wilshire and Western Sandwiches, Inc., drafting resolutions, minutes, etc. Conference H.B.C." That is Harry B. Carpenter. And a charge to services for reincorporation, permit, lease, and related matters, \$250.00.

So I would say that on those days I was working on the resolutions and the minutes, preparing the

(Deposition of Robert A. Odell.)

matter for this meeting. Now, whether it was fully completed at that time or the draft was in a rough form or what, I have no recollection. But I might explain that I don't want to volunteer things in addition to what is asked me, although I might say this: that our firm has many, many years followed a custom in its business of having the individual members enter on a daybook each day things that occur. We don't always get it all in, but there is a record there of various things, cash transactions, and everything else.

These daybooks are gathered up each morning in our Los Angeles office, and the same thing is done in our Santa Monica office, and the books are gathered up there and duplicates are made of the entries on those books. The Santa Monica office sends its copy here and we send a copy to the Santa Monica office, so we have duplicate records in our Los Angeles and in our Santa Monica offices.

We put down various things that happen. We have found [276] frequently it is helpful as a reminder of what we have done and our charges and all that kind of thing.

These entries I speak of were made in the regular course of business and copied in that way.

Q. Mr. Odell, the minutes with respect to which we have been speaking contain a resolution authorizing the issuance of notes to each of Harry B. Carpenter, M. A. McDonnell, Mike Lyman, and William H. Simon. Can you state whether those notes spoken about in those minutes were ever

(Deposition of Robert A. Odell.)

issued? A. Yes.

Q. When were they issued?

A. Well, they were drafted by me, prepared by me, and they were dated November 13, 1941. They were delivered by December 5, 1941. Now, the reason I say by December 5th is that on December 5, 1941, I wrote to Mr. Carpenter and delivered the certificate of stock to him for 1,000 shares and a promissory note—one of these notes—to him for \$8,333.34. In the letter I state—and I have a copy of it before me—that I have delivered promissory notes of the corporation as follows:

“M. A. McDonnell, \$8,333.33; William H. Simon, \$4,166.67; Mike Lyman, \$4,166.66.”

I wrote to Mr. McDonnell on December 5, 1941, and enclosed Certificate No. 2 for 1,000 shares, and also the promissory note from the corporation to him in that same sun. [277]

I do not find any letter to Mike Lyman or William H. Simon, so I don't know whether I mailed it to them or delivered it to them. I wouldn't think I went over there to deliver it to them, but I just can't recall quite how that was done, whether it was by messenger or somebody picked it up, or what.

Q. In any case, your letter of December 5th, addressed to Mr. Carpenter, by December 5th the notes had been delivered to Mr. Simon and Mr. Lyman. Have you any evidence as to the date when you mailed that letter to Mr. Carpenter, which bears the date December 5, 1941?

A. Well, I find in my file a registry return re-

(Deposition of Robert A. Odell.)

ceipt showing a receipt by Mr. Carpenter 12-6-41. I am quite familiar with Mr. Carpenter's handwriting, and this is his signature. The return card is dated at Glendale December 6, 1941, and the letter to Mr. Carpenter was addressed to him at 625 Cumberland Road, Glendale.

This isn't clipped on the copy of the letter, but it is in my files. I find a memorandum on the letter, "Copy of letter to Mr. Carpenter (registered)." I am quite sure that is the return receipt of that registered letter with the stock and the note.

Mr. Maiden: It is stipulated by Respondent that his counsel has read the return receipt of a registered letter and that the contents of this receipt are as just testified to by Mr. Odell. [278]

Q. (By Mr. Webster): Mr. Odell, again referring to the November 13, 1941, minutes, they contain a resolution dealing with the issuance of shares of stock to the same four individuals about whom we have been speaking and to whom you have testified notes were delivered. Were such share certificates issued? A. Yes.

Q. In what amounts?

A. Well, you have the certificate book there?

Q. I show you Petitioner's Exhibit No. 17, which has been identified as the stock ledger book of Wilshire and Western Sandwiches, Inc.

A. I am familiar with that. The writing on these stubs, except as to the receipt for the stock, is in my handwriting, and I filled out the stock certificates and filled out the stubs.

(Deposition of Robert A. Odell.)

Q. When were those stock certificates issued?

A. Well, they were dated November 13, 1941, and that is my best recollection. The canceled stock certificates in here, which were issued at that time, bear the same date.

Q. You are referring to Certificates Nos. 3 and 4?

A. Nos. 3 and 4. Those were surrendered in order that some small block of stock could be issued to Mr. Lardemer.

Q. There is a reference in your letter of December 5, 1941, addressed to Mr. Carpenter, as to the delivery of stock [279] certificates. Are these the stock certificates to which that letter refers?

A. Well, the stock certificates of which these are stubs—in other words, the original stock certificates to Carpenter and McDonnell are not here, but the stubs are.

Q. What I meant was, your letter of December 5, 1941, which you were talking about a few moments ago, I believe makes reference to delivery of stock certificates. A. Yes.

Q. Are these the stock certificates, that is, is this the stock ledger book for the certificates with respect to which that December 5th letter was referring?

A. It is the book of stock certificates, and my letter had reference to the original certificates which were issued from this book, and as to which there is a stub entry on this book.

Q. Would you, therefore, state the dates on which these stock certificates were delivered?

(Deposition of Robert A. Odell.)

A. Well, they were delivered on the 5th of December, 1941, as to Mr. Carpenter and Mr. McDonnell. As I said before, I am not certain just when they were delivered to Mr. Simon and Mr. Lyman, but it was on or shortly before the date; certainly, between November 13, 1941, and December 5th.

I note that Mr. McDonnell signed a receipt for his and that receipt is dated the 5th of December. It is signed for Mr. McDonnell by Mr. Jobson. Mr. Jobson was in Mr. [280] McDonnell's employ. These other dates of the receipt, on the bottom of the stubs, don't seem to be filled in; sometimes we are careless about that.

Q. Calling attention to the revenue stamps which are placed on the stubs of these certificates, do you know when those stamps were attached?

A. Well, they were bought on December 3, 1941.

Q. As a source of information, do you have any information on that, Mr. Odell?

A. I have an entry in this firm journal under date of December 3, 1941, "Wilshire and Western Sandwiches, Inc. Charge. Paid revenue stamps, \$33.60."

I also have a memorandum here from the Wilshire and Western files dated 11-27-41, signed by R.A.O.—that is me—to E.S.—that is Mr. Shilling, an attorney in our employ—in which I requested him to get these revenue stamps and specified the denominations. That is dated 11-19-41. It bears the stamp of the post office, "Los Angeles, California, Metropolitan Station. December 3, 1941."

(Deposition of Robert A. Odell.)

Mr. Webster: Off the record.

(Discussion off the record.)

Mr. Webster: On the record.

Mr. Maiden: Referring to the office memorandum record dated 11-27-41, about which Mr. Odell has just testified, Respondent hereby stipulates that the contents of said memorandum [281] are as testified by Mr. Odell.

The Witness: To answer a little further, the denominations here which I asked Mr. Shilling to get, two tens, two ones, twenty-five cents, it looks like, and two fifty cents: that corresponds exactly with the revenue stamps on these stubs. Now, whether they were canceled later or not—they must have been canceled later. That looks like my writing. It may have been Mr. Bassett's, who came in here checking over the books at a later time in 1946.

Q. (By Mr. Webster): Who was Mr. Bassett?

A. He was connected with the Internal Revenue Department. "George L. Bassett, D. C."—whatever that means

Q. He was, in any case, an official of the Collector's office that checked over these stamps, is that correct?

A. That is right. Somebody comes in periodicaly from the Internal Revenue office and will say, "Let's see the books of such and such corporation."

I say, "Here they are," and he goes through them.

It very well may be I put those on and didn't

(Deposition of Robert A. Odell.)

cancel them at the time. They were charged and paid for on that date. By the ledger account of our firm it shows the stamps were paid for in that amount, as shown by that book. This is a copy of the statement I rendered to Wilshire and Western Sandwiches, December 4, 1941, showing the payment of those revenue stamps.

Q. Mr. Odell, you have been testifying with respect to [282] four notes dated November 13, 1941, issued, respectively, to Mr. Simon, Mr. Lyman, Mr. Carpenter, and Mr. McDonnell. Were there any other notes issued to any or all of these individuals by Wilshire and Western Sandwiches, Inc.?

A. Any other notes? I don't recall any at this moment.

Q. In any case, were there ever any notes issued prior to November 13, 1941, or thereabouts, to these four individuals.

A. Well, I don't think so. I don't recall any others. I prepared these, originals of these notes, of which I have a copy.

Q. And you know of no others? A. No.

Q. Mr. Odell, you have been testifying with respect to the issuance of certain shares of stock to these four individuals and also certain shares to Lardemer. Were there any other share certificates issued by Wilshire and Western Sandwiches, Inc., than those which you have been speaking about?

A. None of which I have any knowledge. There were two stock certificates issued—whatever is shown here by the separate stubs—being a reissue out of the Simon-Lyman stock.

(Deposition of Robert A. Odell.)

Q. In the course of your professional practice have you ever had occasion to back-date any document more than one [283] or two days after the particular event?

A. No, I don't back-date documents.

Mr. Webster: Thank you, Mr. Odell. That is all.

Cross Examination

By Mr. Maiden:

Q. Mr. Odell, have you handled the tax matters and did you handle the tax matters of Wilshire and Western Sandwiches, Inc., from its organization through the years 1942 and 1943?

A. No, I didn't handle any tax matters whatever for them.

Q. Do you do any federal income tax work at all, Mr. Odell?

A. Well, to a certain extent, that is, in connection with estates, making fiduciary returns, and sometimes for our clients. We don't like to do it, but it sometimes happens a client will wish you to do it, so we go through it. But we don't desire to, and many times in estates, if they are at all complicated, we have an outside tax accountant do that.

Q. Mr. Odell, do you recall whether or not Mr. Carpenter or Mr. Simon or Mr. Lyman or Mr. McDonnell discussed with you at any time during 1941 and prior to the issuance of the notes and stock certificates, which you have testified about, why it was that the stockholders were proposing to take a part of their advancement to the [284] cor-

(Deposition of Robert A. Odell.)

poration required to build its drive-in and equip it for business, in notes instead of all in stock?

A. I don't think they knew how much it was going to cost. Certainly, as it afterward developed, it cost a great deal more than was originally contemplated. Mr. Carpenter discussed the matter with me, with respect to subscribing so much for stock, and then borrowing what they needed to complete the building from the individual stockholders. But the purpose or the purport of it was not particularly discussed. That is, I don't recall the discussion about that. I am sure I never had any discussion with any of the other gentlemen at all about the matter, except when we had the meeting and authorized the issuance of the notes. You see, Mr. Carpenter was doing the discussing with me.

Q. Mr. Odell, do you recall whether or not it was the intention of the incorporators and eventual stockholders of this corporation that they would purchase from the corporation sufficient shares of its stock with which to furnish the money required to build the drive-in and equip it for business?

A. No, I think they—well, I don't want to guess at things and say what I think. I want to answer your question.

Q. Before answering that question, Mr. Odell, I might refresh your recollection with Exhibit 4-D to the stipulation of the parties in the case, which is a copy of a petition filed with the Corporation Commissioner for permission [285] to issue shares of stock.

(Deposition of Robert A. Odell.)

I call your attention to a provision appearing on page 4 of this exhibit, to the effect that "It is proposed also to sell additional of its stock for cash to the incorporators, if it should become necessary to do so, for the purpose of completing the building or equipment or for further expanding the business or facilities thereof."

Does that refresh your recollection any on the point?

A. This petition states, in the first part of that paragraph, that "It is proposed to sell and issue at this time 1,500 shares of the stock for that purpose, and to pay the expenses of incorporation and to borrow from the individual stockholders or incorporators additional money sufficient to complete the building and equipment."

And this last statement, "It is proposed also to sell additional of its stock for cash . . . should it become necessary . . . for the purpose of completing the building": now, not to be argumentative at all, but it is my recollection that they didn't know just how much it was going to cost. They thought it would be somewhere around \$30,000; to use this \$15,000 worth of stock issued, and borrow money, if necessary.

Experience has shown, a lot of these drive-ins have cost a good deal more than was originally contemplated.

So that the statement should also be made, they might not have made those individual loans or made the borrowings, [286] but they wanted to be

(Deposition of Robert A. Odell.)

in a position to issue additional stock to the original stockholders if they desired so to do. The prayer of the petition was for the issuance of all the stock to them for cash, notwithstanding it had also said \$15,000 at that time. My recollection is that the permit was made to issue them the whole seventy-five thousand, which, of course, didn't mean they had to take it.

Q. Now, Mr. Odell, this stipulation of the parties discloses that either some or all of the stockholders in the petitioner in this case likewise organized and became stockholders in various other drive-in restaurants of the type operated by this petitioner, and that in each one of these cases stock and documents, denominated notes, were issued to cover the advances made for the construction of the buildings and equipment. Do you recall whether or not you likewise handled the incorporation arrangements in those other corporations?

A. Well, the only one I had to do with was the Sunset Sandwiches, and the other corporation where they—I have forgotten just who all were in that; there was a different personnel there.

Q. The stipulation will show that, I believe.

A. Yes. The Scrivners, Hulsmans, McDonnell, Carpenter, Lyman and Simon.

Q. That is the only other corporation for this group of men that you prepared the corporation records and minutes [287] and issuance of stock and notes, and so forth?

A. That is right. There was one, Manveda, Inc.,

(Deposition of Robert A. Odell.)

which has since been dissolved. I don't think it was of the same structure.

Q. But, Mr. Odell, I believe that you have testified that the purpose these stockholders had in mind in this particular case, in taking part of their advancement in the form of loans, was not discussed with you.

A. I don't know what you mean, "taking advancement in the shape of loans."

Q. I might call your attention to the fact, Mr. Odell, that in the stipulation it is stipulated that, beginning in May 1941, and ending on November 19, 1941, the stockholders in this corporation had advanced to the corporation the sum of \$55,000.

Now, it has further been developed in the case that stock was not issued for that entire amount of money advanced, but that part of the advancement, total advancement, was taken in the form of promissory notes issued to the stockholders.

Now then, I want to know whether or not these stockholders advised you why it was that they wanted to take part of the advancement in notes, rather than taking it all as stock.

A. Well, I don't know about the \$55,000. The original plan, as shown by, or, at any rate, developed at [288] the time the application was made to the Corporation Commissioner, it was rather plain that the stock which they proposed to actually buy at that time was \$15,000. I don't recall, but I rather think the building proceedings were going on during the summer and up to the time when

(Deposition of Robert A. Odell.)

this action was taken on November 13th. The \$15,000 in stock evidently increased to \$30,000 by that time, and the advancements made amounted to this other sum, \$25,000.

There had been a rather general understanding, as I got it from Mr. Carpenter, that they would buy some stock and make individual loans from the incorporators to carry on the building, but they weren't obliged to.

Q. I am not asking you that. Of course, that is a matter of law. But the point I am trying to clear up in the record is whether or not these stockholders, after the building had been completed, the money had been advanced, that they preferred to take part of their advancement in the form of notes rather than entirely as stock.

A. Not at that time. I think that was the idea right along. What was contemplated was, they would buy stock and they would also make loans.

Q. Did they tell you why they did not want to put up the entire amount of money required in the form of stock purchases?

A. No, that wasn't discussed, that I recall, to any extent. I don't remember discussion about it, excepting they [289] didn't know what the building was going to cost, and they — when I say "they", please understand I mean only Mr. Carpenter, who had talked to me about the matter. I didn't talk to these other gentlemen about it in the formative stages. I assumed he spoke for them. And when I held the meetings, what took place,

(Deposition of Robert A. Odell.)

of course, was actually as shown by the minutes. I didn't go into detail talking with all these other gentlemen about any of these things, except when we held the meetings.

Q. Mr. Odell, I don't mean to be impertinent or to in anywise impinge your absolute integrity, but Mr. Carpenter testified in this case that notwithstanding the fact that he had signed the affidavit attached to the petition to the Corporation Commissioner, which affidavit of course states that he had read and understood the contents of that application, that he, in fact, didn't read it and didn't know its contents. Do you recall whether or not you presented this application to Mr. Carpenter to be read by him and notarized?

A. This is a copy of the certified original. He signed it and swore to it before me on that day. That is what happened. I don't know what Mr. Carpenter testified to. I didn't talk to him about his testimony.

Mr. Maiden: Well, you can rely upon my statement he did testify to that, in substance. I think Mr. Webster will agree. I believe that is all. [290

Redirect Examination

By Mr. Webster:

Q. Mr. Odell, is Mr. Carpenter a client of your firm? A. Yes.

Q. How long has he been a client of your firm, approximately?

A. Oh, about 35 years ago. By that I mean that over that period of time, from time to time, he

(Deposition of Robert A. Odell.)

has employed us and we have represented him in legal matters, for places he has been interested in. That doesn't mean that he doesn't have other attorneys at times. I don't know what other attorneys he may have.

Q. You are a senior partner in this firm of Tanner, Odell & Taft?

A. Well, I don't want to emphasize the senior part of it. Mr. S. W. Odell, my uncle, is my senior in years in the firm. But Mr. Donald Odell is my cousin and junior in years. Mr. Taft is my junior in years.

Q. How many do you have in this firm, Mr. Odell?

A. Well, we have four now. Judge Taft and Judge Tanner passed away; Mr. Shilling is associated with us.

Mr. Webster: That is all.

/s/ ROBERT A. ODELL.

Subscribed and sworn to before me this 15th day of January, 1948.

/s/ VIRGINIA K. PICKERING,
Notary Public in and for the County of Los Angeles, California.

My Commission expires May 10, 1951. [291]

To the Tax Court of the United States:

I, Virginia K. Pickering, the person named in the attached stipulation to take deposition, hereby certify:

(Deposition of Robert A. Odell.)

1. That I proceeded on the 22nd day of December, A. D. 1947, at the offices of Tanner, Odell & Taft, 1011 Van Nuys Building, 210 West 7th Street, in the City of Los Angeles, State of California, at 4:00 o'clock p.m., under the said stipulation to take deposition, and in the presence of Martin H. Webster and R. E. Maiden, Jr., the counsel of the respective parties, to take the following deposition, viz:

Robert A. Odell, a witness produced on behalf of the Petitioner.

2. That the witness was examined under oath at such times and places as conditions of adjournment required, and that the testimony of the witness was taken stenographically and reduced to typewriting by me or under my direction.

3. That after the testimony of the witness had been reduced to writing the transcript of that testimony was read and signed by the witness in my presence and that the witness acknowledged before me that his testimony was in all respects truly and correctly transcribed.

4. That, after the signing of the deposition in my presence, no alterations or changes were made therein.

5. That I have no office connection or business employment with the Petitioner or its attorney.

/s/ VIRGINIA K. PICKERING,
Notary Public in and for the County of Los Angeles, State of California. [292]

My commission expires May 10, 1951.

[Title of Tax Court and Cause.]

STIPULATION TO TAKE DEPOSITION

It Is Hereby Stipulated and Agreed by and between the parties to the above entitled action, through their respective counsel, that the testimony of Robert A. Odell witness on the part of Petitioner in said action, may be taken pursuant to Rule 45 of the Rules of Practice before the Tax Court of the United States, before Virginia K. Pickering, Notary Public in and for Los Angeles County, California, on Monday, the 22nd day of December, 1947, at 1011 Van Nuys Building, in the City and County of Los Angeles, California, at 4:00 o'clock in the afternoon of said day, and if said deposition is not completed on said day, it may be continued from day to day thereafter until same is completed.

It Is Further Stipulated and Agreed that the testimony may be written down in shorthand writing by a shorthand reporter and thereafter transcribed into writing and shall then be read to or by the said witness, corrected, subscribed and sworn to by said witness; that the said deposition and testimony, when so taken, may be read and used in evidence in said cause by either party on any trial of said action or proceeding therein, subject to the same objections and exceptions as if said witness were personally present on the witness stand, but without objection or exception to the time, place

or manner of taking the same, or the form of the question, unless noted at the time.

Dated this 22nd day of December, 1947.

/s/ MARTIN H. WEBSTER,
Attorney for Petitioner.

/s/ R. E. MAIDEN, JR.,
Attorney for Respondent.

General Reporting Company, 215 West 5th
Street, Los Angeles, Calif. MICHIGAN 4341. [293]

[Title of Tax Court and Cause.]

STIPULATION

It is hereby stipulated by and between Wilshire and Western Sandwiches, Inc., Petitioner, and the Commissioner of Internal Revenue. Respondent, by their respective counsel, that the following facts shall be taken as true; provided, however, that this stipulation shall be without prejudice to the right of either party to object at the hearing to any part thereof on the grounds of immateriality, or to introduce other and further evidence not at variance with the facts herein stipulated;

1. The tax years involved are the calendar years 1942 and 1943.

2. The Petitioner is a corporation organized under the laws of California with its principal place of business at 3180 West Sixth Street, Los Angeles, California. It filed its returns for the tax years involved with the Collector for the Sixth

District of California. The Petitioner kept its books and prepared its returns on the accrual basis.

3. The Petitioner was incorporated March 24, 1941 with an authorized capital stock of 7500 shares of common stock of the [284] par value of Ten Dollars (\$10.00) per share. Petitioner was formed for the purpose of engaging in the drive-in restaurant business. In addition to other powers granted to it in its Articles of Incorporation, Article XII empowers the corporation to borrow money and issue its notes therefor.

4. On April 26, 1941, a lease was entered into between Robert Ashley Pettey and Julia Faye Pettey, lessors and Wm. H. Simon, lessee. A copy of the provisions of the lease which are deemed relevant is attached hereto as Exhibit No. 1-A to this Stipulation.

5. On May 2, 1941, a Supplement to Lease was executed between the same parties who executed the lease dated April 26, 1941. A copy of this supplement is attached hereto as Exhibit No. 2-B.

6. Commencing May 17, 1941, payments were made to the Petitioner by the following individuals and in the following amounts:

Date	Advanced by	Amount
5/17/41	M. A. McDonnell	\$ 3,333.33
6/ 9/41	Wm. H. Simon and Mike Lyman (half each)	3,333.33
6/ 9/41	Harry B. Carpenter	3,333.34
8/22/41	Wm. H. Simon and Mike Lyman (half each)	5,000.00
9/12/41	M. A. McDonnell and Harry Carpenter (half each)	10,000.00

10/30/41	Wm. H. Simon and Mike Lyman (half each)	5,000.00
Date	Advanced by	Amount
10/30/41	Harry B. Carpenter	5,000.00
11/13/41	Wm. H. Simon and Mike Lyman (half each)	5,000.00
11/13/41	Harry B. Carpenter	5,000.00
11/19/41	M. A. McDonnell	10,000.00

The total of all payments from the four individuals above named was Fifty-Five Thousand Dollars (\$55,000) divided as follows:

Name	Amount
Harry B. Carpenter.....	\$18,333.33
M. A. McDonnell.....	18,333.33
Wm. H. Simon.....	9,166.67
Mike Lyman	9,166.66

7. The monies paid as outlined in Paragraph 6 hereof were first used by the Petitioner to defray expenses for preparation of plans and specifications for the erection of a building on the leased premises. Said monies were thereafter used to pay for the construction of the drive-in building and the equipment thereof. A summary of the total amounts so expended, per the books, broken down by months and allocated between building and equipment is set forth below: [296]

	Building	Equipment	Total to Date
1941			
June	\$ 750.00	\$ 750.00	\$ 1,500.00
July	1,011.08	545.00	3,056.08
August	7,129.53	521.02	10,706.63
September	8,864.55	2,272.75	21,843.93
October	5,926.95	1,098.02	28,868.90

			Total to Date
1941	Building	Equipment	
November	3,828.17	1,373.20	34,070.27
December	8,005.77	8,955.79	51,031.83
Add: Prepaid Expenses per Journal Entry Page 6	2,598.63	2,000.00	55,630.46
Total—1941	\$38,114.68	\$17,515.78	\$55,630.46
1942			
January	\$ 2,375.00	\$ 123.60	\$58,129.06
February .....	.....	7,663.66	65,792.72
Totals	\$40,489.68	\$25,303.04	\$65,792.72

8. On or about June 15, 1941, the architect for the proposed building of the Petitioner, Joseph L. Feil, solicited bids for the construction of said building. Four bids were received as follows: [297]

Bidder	Minimum Amount	Date of Bid
Lynch Cannon Construction Co.....	\$21,000.00	6/20/41
Nowell M. Calhoun	19,327.00	6/20/41
Hastings-Quinn, Inc.	18,875.00	6/21/41
Frank A. Woodyard	18,222.00	6/20/41

On July 10, 1941, a building construction contract was entered into between the Petitioner and Frank A. Woodyard under which Frank A. Woodyard agreed to construct a drive-in building and adjacent service building for the sum of Twenty-Two Thousand Six Hundred Fifty-one Dollars (\$22,651.00). Frank A. Woodyard commenced erection of the drive-in building on or about July 25, 1941. By on or about October 25, 1941, the work of Frank A. Woodyard had been substantially completed.

9. On July 14, 1941, the board of directors of the Petitioner held its first meeting. A copy of

the minutes of said meeting are attached hereto as Exhibit No. 3-C.

10. On July 14, 1941, the President and Secretary of the Petitioner applied to the Commissioner of Corporations of the State of California for a permit to issue shares of its stock as set forth in the application, a copy of which is attached hereto as Exhibit No. 4-D. On July 17, 1941, a permit was issued by the Corporation Commissioner of the State of California authorizing the issuance of 7500 shares at par for cash, all in accordance [298] with said permit, a copy of which is attached hereto as Exhibit No. 5-E.

11. On July 14, 1941, Wm. H. Simon, lessee under the lease hereinabove described in Exhibit No. 1-A, duly assigned to the Petitioner as assignee said lease and the supplement thereto dated May 2, 1941, hereinabove described in Exhibit No. 2-B. Consent to said assignment was duly obtained on August 14, 1941. A copy of said assignment is attached hereto as Exhibit No. 6-F.

12. On August 22, 1941, a lease was entered into between Edna R. Vogel, lessor, and the Petitioner, lessee, covering premises adjacent to the property theretofore assigned to the Petitioner by Wm. H. Simon as original lessee and on which the drive-in restaurant was constructed. Said premises were to be used for parking purposes. A copy of said Vogel lease is attached hereto as Exhibit No. 7-G.

13. On or about November 15, 1941, the Petitioner commenced doing business as a drive-in restaurant.

The bank balance of the Petitioner on February 1, 1942 was One Thousand One Hundred Twenty-Six Dollars and Ninety-Eight Cents (\$1,126.98).

14. On the following dates, checks of the Petitioner were issued and delivered to the following named persons in the amounts indicated, with an explanation in the voucher portion of each check as follows: [299]

Name	Date	Amount	Explanation on Voucher
Harry B. Carpenter	4/21/43	\$3,333.34	"Payment on Note"
M. A. McDonnell		3,333.33	"Payment on Note"
Wm. H. Simon		1,666.16	"Payment on Note"
Mike Lyman		1,666.16	"Payment on Note"
Harry B. Carpenter	5/23/44	3,333.33	"Note Acct."
M. A. McDonnell		3,333.34	"Note Acct."
Wm. H. Simon		1,667.17	"Note Acct."
Mike Lyman		1,667.17	"Note Acct."
Harry B. Carpenter	3/23/45	1,666.66	"Bal. on Note"
M. A. McDonnell		1,666.66	"Bal. on Note"
Wm. H. Simon		833.34	"Bal. on Note"
Mike Lyman		833.34	"Bal. on Note"

15. There are attached hereto as Exhibit Nos. 8-H, 9-I and 10-J, respectively, Corporation Income and Declared Value Excess-Profits Tax Returns filed by the Petitioner for the calendar years 1941, 1942 and 1943.

16. The stockholders of Petitioner, or some of them, have entered into similar transactions wherein they advanced [300] money to other corporations for a portion of which they received capital stock thereof and for the balance of which they received documents designated "Promissory Notes". A list of such similar transactions is set out below:

Name of Corp.	Date of Incorporation	Date Com- menced Business	Capital Structure	Stockholders and Lenders
F & LB Corp.	1/17/41	10/ 1/41	\$36,000.00 stock 54,000.00 notes	M. A. McDonnell, B. W. Hulsman, Al Simon, Mike Lyman, Wm. H. Simon, H. Carpenter, L. J. Evans
M & S Foods Inc.	12/28/40	7/ 1/42	\$36,000.00 stock 108,000.00 notes	B. W. Hulsman, M. A. McDonnell, Al Simon, Mike Lyman, Wm. H. Simon, L. J. Evans, H. L. Scrivener, Dorothy Marcus Lyman
Carsim, Inc.	10/ 1/37	6/ 1/39	\$30,000.00 stock 7,500.00 notes	Wm. H. Simon, Mike Lyman, Albert Simon, H. Carpenter. Hallie McDonnell, Ben Hulsman
Simon's Florat, Inc.	2/ 6/41	11/—/41	\$10,000.00 stock 38,097.09 notes	Wm. H. Simon, Mike Lyman, M. A. McDon- nell, H. Carpenter, J. Lardener
Simon's Beverly Inc.	6/10/40	2/—/41	\$ 9,900.00 stock 29,348.78 notes	Wm. H. Simon, M. A. McDonnell, L. J. Evans, J. A. Lardener, Al Simon, B. W. Hulsman, Mildred Evans, Mike Lyman
Simon's Five Points, Inc.	2/ 3/41	11/ 1/41	\$10,000.00 stock 41,782.30 notes	Wm. H. Simon, Mike Lyman, J. Lardener, H. Carpenter, M. A. McDonnell
Simon's Wash- ington, Inc.	1/ 7/41	9/23/41	\$10,000.00 stock 9,498.08 notes	Wm. H. Simon, Mike Lyman, M. A. McDon- nell, J. Lardener, E. J. Aye
Sunset Sand- wiches, Inc.	8/16/40	1/29/41	\$18,000.00 stock 16,000.00 notes	H. L. Scrivener, C. W. Scrivener, B. W. Huls- man, M. A. McDonnell, H. B. Carpenter, Wm. H. Simon, Mike Lyman
Carleton's Inc.	3/24/37	1937	\$ 7,000.00 stock 2,000.00 notes	M. A. McDonnell, B. W. Hulsman, Ben Carle- ton

In two of the above listed corporations, the notes were not in proportion to the investments made for capital stock. Details are as follows: [302]

Name	Percent of Notes	Percent of Stock
Sunset Sandwiches, Inc.		
H. L. Scrivener	25	16.67
C. W. Scrivener	25	16.67
H. B. Carpenter	25	16.67
H. B. Carpenter, Jr. ....	....	16.67
M. A. McDonnell	8.33	11.11
B. W. Hulsman	8.33	11.11
Wm. H. Simon	4.17	5.55
Mike Lyman	4.17	5.55
Carleton's, Inc.		
M. A. McDonnell	50	26.07
B. W. Hulsman	50	26.07
B. Carleton .....	....	47.85

In all other of the above listed corporations, the notes were in proportion to stockholdings.

17. In all of the above corporations, with the exception of Carleton's, Inc., the Commissioner of Internal Revenue has refused to recognize the documents designated promissory notes as bona fide loans of money by the stockholders to the corporations, but has treated the amounts represented by the notes as investments in the businesses. Appeals are now pending before this Court from the afore-said action of the Commissioner in Simon's Florat, Inc., Docket No. 15309; Simon's Five Points, Inc., Docket No. 15305; Simon's [303] Washington, Inc., Docket No. 15306; Simon's Beverly, Inc., Docket No. 15308; Carsim's, Inc., Docket No. 15307; and Sunset Sandwiches, Inc., Docket No. 10637. In F & LB Corporation and M & S Foods, Inc., 30 day letters have been issued, and 90 day letters will soon be issued.

18. Nothing in paragraph 16 above should be construed as an admission on the part of respondent that the documents designated promissory notes were in fact loans to the corporations, it being respondent's contention as aforesaid that the amounts represented by said notes are in fact investments in the businesses.

/s/ MARTIN H. WEBSTER,
Counsel for Petitioner.

/s/ CHARLES OLIPHANT,
Chief, Counsel, Bureau of Internal Revenue, Counsel for Respondent. [304]

EXHIBIT No. 1-A

LEASE

This lease, made and entered into this 26th day of April, 1941, by and between Robert Ashley Pettey and Julia Fay Pettey, Trustees of the Estate of Mary Emma Pettey, Deceased, hereinafter called lessors; and William H. Simon, hereinafter called lessee;

Witnesseth:

That, in consideration of the payment of rents and performance of the other covenants and agreements herein provided to be kept and performed by the lessee, and on condition that the rents herein provided shall be paid when due, and that each and all of the covenants and agreements herein provided shall be duly and fully performed by the lessee, the lessors have leased, demised, and let, and

Exhibit No. 1-A—(Continued)

by these presents do lease, demise, and let, unto the lessee those certain premises situated in the City of Los Angeles, County of Los Angeles, State of California, more particularly described as follows:

Lots 1 and 2 in Block H of Westminster Place, as per map thereof recorded in the office of the County Recorder of the County of Los Angeles, State of California, in Book 9, Page 61 of Maps;

together with all the rights, easements, and appurtenances to the real property belonging and appertaining and usually had and enjoyed therewith; and all upon and subject, however, to the terms, conditions, exceptions, reservations, restrictions, and provisions herein contained or mentioned;

To have and to hold the same unto the lessee for the term herein specified, and upon the terms, conditions, provisions, and covenants, and subject thereto as in this entire lease set forth, contained, and mentioned. [305]

Lessors hereby represent and warrant that they are the legal owners of said real property herein demised. Lessors further covenant with lessee that the herein-demised land is not zoned or restricted against the uses for which the said land is hereby demised, and lessors further covenant with the lessee that the said demised premises may be used by the lessee for the purposes herein set forth.

Exhibit No. 1-A—(Continued)

I.

TERM

The term of this lease shall be for a period of fifteen (15) years, commencing on the 30th day of April, 1941, and ending on the 29th day of April, 1956.

II.

CONSTRUCTION OF BUILDING

It is hereby agreed, by and between lessors and lessee, that upon the delivery of possession of the above-demised premises to lessee as hereinbefore provided, lessee shall commence the preparation of plans and specifications for the said proposed restaurant building, and thereafter diligently prosecute the work of constructing said building so that a late-model drive-in restaurant building will be erected on the demised premises within approximately 120 days after possession of said premises has been delivered to lessee. The plans and specifications for said building shall be approved in writing by both lessors and lessee, and may, at the option of lessee, provide for the erection of a cocktail bar.

The lessee shall bear the entire cost of constructing said building and equipping and furnishing the same. The said total cost of the entire work of improvement, including the [306] equipment and fixtures installed in said building, shall be not less than \$30,000.00.

Exhibit No. 1-A—(Continued)

The time within which it is contemplated that the drive-in restaurant building will be erected, to-wit, 120 days, shall be extended or such period of delay as may be caused by strikes, lockouts, acts of God, or other conditions beyond the control of lessee.

III.

RENTAL

(a) Lessee agrees to pay as rental for said demised premises during the entire period of this lease an amount equal to six per cent (6%) of the total gross sales made in connection with the business conducted in, on, or from the demised premises as hereinafter more particularly defined, which said payments shall be hereinafter referred to as "percentage rental"; provided, however, that lessee agrees (subject to the abatement provision hereinafter contained) that said rental shall not be less than Seven Hundred Dollars (\$700.00) each month during the term of this lease. Said minimum monthly rental payments of Seven Hundred Dollars (\$700.00) per month are hereinafter referred to as "guaranteed minimum monthly rentals".

In addition to said guaranteed minimum monthly rentals lessee agrees to pay the amount of taxes and assessments hereinafter referred to and provided for in articles XV and XVI hereof.

(b) Said guaranteed minimum monthly rental of Seven Hundred Dollars (\$700.00) each month shall be payable monthly in advance on the first

Exhibit No. 1-A—(Continued)

day of each and every calendar month of the term of this lease after the end of the abatement period hereinafter provided for; provided, however, that, in [307] the event the day for the commencement of said guaranteed minimum monthly rental shall be a day other than the first day of a calendar month, then the first installment of guaranteed minimum monthly rental shall be equal in amount to that portion of Seven Hundred Dollars (\$700.00) as the number of remaining days in said month bears to the total number of days in said month, and thereafter the full guaranteed minimum monthly rental installments shall be paid on the first day of each calendar month of the remainder of the term of said lease.

In addition to guaranteed minimum monthly rentals, lessee hereby covenants and agrees to pay as rental, in the manner provided for in Article XIV hereof, the amount by which the percentage rental exceeds the guaranteed minimum monthly rental required to be paid hereunder. The percentage rental shall be computed monthly, and payment of the excess over the minimum guaranty shall be made in the manner provided for hereinafter in Article XVI.

IV.

GROSS SALES

The term "gross sales" as used herein shall mean and include the full value received by lessee, and by any assignee, sub-lessee, or licensee of lessee,

Exhibit No. 1-A—(Continued)

from all transactions, including all sales, trades, exchanges, and transfers of merchandise of any kind, made upon or from the demised premises or in connection with any business carried on upon the demised premises, whether such merchandise be prepared or consumed upon the demised premises or otherwise, and whether such transactions be at wholesale or retail or for cash or on credit, and in case of sales made on credit, whether payment therefor is actually made or not. [308]

The term "gross sales" shall include all the net revenue received by lessee from sales or transactions from all vending machines upon the demised premises which are not owned by lessee, and all the gross revenue from all vending machines upon the demised premises which are owned by lessee.

The term "gross sales" shall include the value received from all such transactions as aforesaid which result from orders or offers received in connection with the business carried on upon the demised premises, regardless of where such orders or offers may be fulfilled.

The term "gross sales" shall not include any value received by lessee from the sale of used grease and used potato sacks, both of which are mere by-products of the operation of lessee's business.

The term "gross sales" as used herein shall also include the total gross income received by lessee from signs, displays, advertising, or any other activity conducted on or about the demised premises.

Exhibit No. 1-A—(Continued)

Notwithstanding the foregoing provisions, in the computation of "gross sales" there shall be excluded the amount of any sales tax paid by lessee to the State of California, the City of Los Angeles, County of Los Angeles, or the United States Government in respect to transactions which are included in the term "gross sales", whether or not the amount of such tax is collected as a separate item by the lessee from his customers.

V.

ABATEMENT OF RENTALS

Anything in this lease to the contrary notwithstanding, the guaranteed minimum monthly rental due and payable pursuant to the provisions of this lease shall abate during [309] the period of the planning and construction of said building; provided, however, that said period of abatement shall not exceed five months from the date of the execution of this lease; and during the said period of abatement the following rentals shall be due and payable in lieu of said guaranteed minimum monthly rentals:

(1) For the first and second months of the term of this lease no rent shall be due and payable;

(2) For the next three months of the term of this lease the sum of Five Hundred Dollars (\$500.00) per month shall be due and payable;

at the time provided for the payment of the guar-

Exhibit No. 1-A—(Continued)

anteed minimum monthly rental which is abated pursuant to the provisions of this paragraph.

* * * *

VII.

USE OF PREMISES

(a) The herein-demised premises shall be used by lessee solely and exclusively under the name "Carpenter's", for the purpose of carrying on a drive-in restaurant, cafe, and, at the option of lessee, a cocktail lounge, and for the sale and consumption of food, drinks, and all other articles of merchandise usually vended or sold from such establishments, and which are customarily sold in establishments of this character by the operators thereof in the City of Los Angeles, County of Los Angeles, State of California.

(b) The lessee expressly covenants and agrees that he will at all times maintain and conduct his business in a lawful manner, and in strict compliance and observance of all governmental rules, regulations, ordinances, or laws, and in strict compliance with all of the restrictions required to be observed by lessors upon the herein-demised property. In any [310] isolated instance of a failure of the lessee to comply with, fulfill, and observe any governmental rule, regulation, ordinance, or law, and such failure be brought to the attention of lessee, and lessee immediately remedy and rectify his failure in such respect, such original failure shall not constitute a breach on the part of lessee

Exhibit No. 1-A—(Continued)

of his covenants and agreements under this lease.

(c) Lessee hereby agrees, during the term of this lease, to operate and keep said business and said business establishment open during the usual business hours of each business day as may be customary in drive-in restaurants in the City of Los Angeles operating a business comparable to that permitted to be conducted by lessee hereunder. Lessee further agrees to conduct and carry on his business on the demised premises in accordance with the present method of conducting the drive-in restaurant establishments operated in the City of Los Angeles, State of California, under the name of "Carpenter's".

* * * *

IX.

UPKEEP AND REPAIRS

The lessee hereby covenants and agrees, at his own expense, to keep the said demised premises, th building, improvements, equipment, grounds, landscaping, and all parts thereof, and all lighting, glass, and fixtures in and upon the same, from and after the erection of the improvement herein contemplated, in good order, repair, and condition, externally and internally, as the same then are at the beginning of this lease, reasonable wear and tear and damages by fire, earthquake, tornado, or other unavoidable casualty only excepted; and it is expressly understood and agreed that lessors shall not be [311] under any obligation or expense

Exhibit No. 1-A—(Continued)

to make any repairs upon the demised premises, or any of the improvements thereon, or to replace or repair or to maintain any of the furniture, furnishings, equipment, or fixtures, but lessee alone shall be responsible therefor. If lessee fails to comply with this provision, lessors at their option may make such repairs and lessee shall repay lessors for such expenditures upon demand.

X.

FIRE INSURANCE

Lessee hereby covenants and agrees to keep insured against loss or damage by fire during the term of this lease any and all buildings or improvements that may be built upon or placed upon said premises, in a good and responsible company or companies doing business in the State of California, to an amount not less than eighty per cent (80%) of the value of said building or buildings, provided insurance in responsible companies doing business in the State of California can be obtained in that percentage, and, if not, then to the highest percentage that can be obtained less than the eighty per cent (80%).

Proceeds from any policy or policies shall be payable to both the lessors and the lessee as their interests may appear, and shall be used by them in trust for the uses and purposes herein after mentioned.

The original policies may be retained by the lessee, but the lessors shall have the right to inspect

Exhibit No. 1-A—(Continued)

any and all policies of fire insurance in the possession of the lessee in which the demised premises or the lessors are included, and the lessee, on demand, will furnish the lessors proof of payment of the premium on any such policies.

If at any time or times the lessee shall fail or [312] neglect to insure any of the premises or to cause the same to be insured as required by the provisions of this lease, then the lessors shall obtain such insurance in lessors' name or as the agent of the lessee in insurance companies satisfactory to said lessors. The amount of any premiums paid for such insurance obtained by the lessors as herein provided shall be forthwith due and payable from the lessee, with interest thereon at the rate of 6% per annum computed from the date of such payment.

XI.

DESTRUCTION OF BUILDING

The lessee hereby agrees that, in the event the premises shall be damaged or destroyed in whole or in part by fire, the elements, acts of God, other casualty or happening, and as often as the same shall occur, this lease and the term hereof shall be unaffected, except as to the abatement of rent hereinafter provided for, and shall continue in full force and effect, except that, if the premises shall be substantially destroyed during the last three years of the term of this lease, lessee shall have the option and privilege of cancelling and termi-

Exhibit No. 1-A—(Continued)

nating this lease upon giving notice to the lessors of such election within thirty days after the happening of any of the events aforesaid; and upon the giving of such notice this lease and the term hereof shall cease, terminate, and come to an end on the date specified in such notice therefor, which date shall be not sooner than twenty days after such notice is given; and both parties shall be and they are hereby released from and relieved of any and all liability and obligation hereunder which shall accrue after such date of termination.

The lessee hereby agrees, upon the happening of any of the events aforesaid, subject, however, to the lessee's [313] right of cancellation during the last three years of the term, to put the demised premises in as good order and condition as the same were in immediately preceding the happening of any of the events aforesaid, or to rebuild the same or construct a new building, as the case may reasonably require, with due diligence, delays occasioned by strikes, lock-outs, and other matters beyond the lessee's control or that of his contractors and materialmen, and delays reasonably occasioned in the settlement and adjustment of losses with insurance companies excepted.

If insurance moneys will be available for such losses as may have occurred, lessee shall have the right to adjust all of such losses without the consent or approval of the lessors, if the lessee so desires, and lessors will execute and deliver receipts or releases therefor as may be required by

Exhibit No. 1-A—(Continued)

the insurance companies; except that lessee will notify the lessors as to the amount of the adjustment on request; and the proceeds from the policies shall be paid to the lessee if the lessee does not elect to terminate this lease as hereinabove provided. If the lessee should terminate this lease as hereinabove provided, the lessors shall have the right to adjust all of such losses with the insurance companies without the consent or approval of the lessee, and shall be entitled to retain all of the proceeds of said insurance.

In the event business cannot be carried on on said demised premises by reason of the happening of any of the foregoing events, then the rentals due under the terms and provisions of this lease shall abate until the premises are in condition for the resumption of business thereon; provided, however, that such period of abatement shall not in any event exceed a period of four months. [314]

* * * *

XIII.

COVENANTS AGAINST LIENS

Lessee expressly covenants and agrees that he will not, during the term hereof, suffer or permit any lien to be attached to or upon said premises, or any portion thereof, by reason of any act or omission on the part of lessee, and hereby expressly agrees to save and hold harmless the lessors and their property from or against any such lien or claim of lien.

Exhibit No. 1-A—(Continued)

In the event any such lien does attach or any claim of lien is made against said demised premises which may be occasioned by any act or omission upon the part of lessee, and shall not be released within five (5) days, lessors, in their sole discretion, may pay and discharge the same and relieve the said demised premises from any such lien, and lessee agrees to repay and reimburse lessors for or on account of any expenses which may be incurred by lessors in discharging such lien or claims, or lessors may treat said default on the part of lessee as a breach of this lease, for which lessors shall be entitled to exercise and have any and all rights given to them in case of default under this lease or under any provision of law relating thereto.

* * * *

XIX.

TERMINATION ON ACCOUNT OF
INSOLVENCY OR RECEIVERSHIP

If any adjudication of bankruptcy or insolvency be made or rendered against lessee, or if a receiver of the business or assets of lessee should be appointed, or in the event of any attachment or execution being levied on the business or assets of lessee, and such attachment and/or execution is not removed within fifteen (15) days, or in the event of any sale or [315] attempted sale of the leasehold interest hereby created, under or by virtue of any execution or other legal or judicial order

Exhibit No. 1-A—(Continued)

or authority, the lessors may, at their option, with or without terminating this lease, enter and remove the lessee and all of the lessee's property from said demised premises, and no person, firm, or corporation shall have any right to use, possess, or occupy said demised premises or any part thereof under or by virtue of any matters or things herein in this paragraph set forth, without the written consent of lessors first had and obtained; provided, however, that neither the happening of any of the contingencies mentioned in this article nor the entry or re-entry of lessors nor the removal by lessors of lessee's property (in the happening of any such contingencies) shall constitute an election upon the part of lessors to terminate this lease, unless written notice to that effect is given by lessors to lessee, but in any event the happening of any such event shall constitute a default under this lease for which lessors shall have the same rights and remedies as provided in the case of any other default hereunder, or by any law relating thereto.

XX.

DEFAULT

In the event of default at any time by lessee in the payment of the rent herein provided for, for more than twenty (20) days, or in the performance of any other of his agreements herein contained, or if lessee vacate or abandon the demised premises for a period of ten (10) days, then in any or either of such events it shall be lawful for lessors,

Exhibit No. 1-A—(Continued)

after three (3) days' notice in writing to lessee of such default, to declare said demised term ended and to re-enter the premises or any part thereof either with or without process of law, lessee hereby waiving notice of any kind or any demand for possession of the demised premises, or [316] for the payment of rent; or lessors at their option, and without declaring the lease ended, may re-enter the premises and occupy or lease the whole or any part thereof for and on account of lessee and on such terms and conditions and for such rent as lessors may with reasonable diligence be able to secure, and may collect said rent or any other rent that may thereafter become payable and apply the same toward the amount due or thereafter to become due from lessee and on account of the expenses of such sub-letting and any and all other damages sustained by lessors. Should such rental be less than that herein agreed to be paid by lessee, lessee agrees to pay such deficiency to lessors, in advance, on the first day of each month hereinbefore specified for payment of rental, and to pay to lessors, forthwith upon any such re-letting, the costs and expenses lessors may incur by reason thereof.

Lessors may execute any such lease, either in their own names or in the name of lessee, as lessors may see fit, and the sub-tenant therein named shall be under no obligation whatsoever to see to the application by the lessors of any rent collected by lessors from such sub-tenant, nor shall lessee have

Exhibit No. 1-A—(Continued)

any right or authority whatever to collect any rent whatever from such sub-tenant.

Lessors shall not be deemed to have terminated this lease or the liability of lessee to pay the rent thereafter to accrue, or his liability for damages, by any such re-entry or by any action in unlawful detainer or otherwise, unless lessors notify lessee in writing that they have elected to terminate this lease; and lessee further covenants that the service by lessors of any notice pursuant to the unlawful detainer statutes of the State of California and the surrender of possession by lessee pursuant to such notice shall not (unless lessors elect to the contrary at the time [317] of or at any time subsequent to the service of such notice) be deemed to be a termination of this lease.

Nothing herein contained shall be construed as obligating lessors to sub-lease the whole or any part of the demised premises.

In the event of any entry and taking possession of the demised premises as aforesaid, lessors shall have the right but not the obligation to remove therefrom all or any personal property located therein and may place the same in storage at a public warehouse at the expense and risk of the owner or owners thereof.

It is further agreed by the parties hereto that after the service of notice or the commencement of a suit or after final judgment for the possession of said premises the lessors may receive and collect any rent due, and the payment of said rent shall not waive said notice, said suit, or said judgment.

Exhibit No. 1-A—(Continued)

XXIII.

ASSIGNMENT AND SUB-LETTING

Except as hereinafter provided, lessee shall not assign this lease or sub-let the whole or any part of the demised premises, or permit any other person, either jointly with the lessee or otherwise, to occupy the premises or any part thereof, without first obtaining on each occasion the written consent of lessor; and said lessee shall not sub-let the whole or any part of said demised premises, or permit any other person, either jointly with said lessee or otherwise, to occupy said premises or any part thereof without such written consent; and neither acceptance of rent by lessors from lessee or from any other person thereafter, nor the failure on the part of lessors for any particular period to take action on account of such breach or to enforce their rights, shall be deemed a waiver of the breach, but the same shall be a continuing breach as long as such sub-tenancy, assignment, or occupancy continues [318]

Lessors understand that it is the purpose of lessee to transfer the leasehold estate created by this lease to a corporation hereafter to be formed by lessee and other parties, and lessors hereby consent to the assignment of this lease to such corporation, provided that such corporation shall in writing assume and agree to perform each, every, and all of the terms, conditions, and covenants contained in this lease and to be performed by lessee herein,

Exhibit No. 1-A—(Continued)

and shall have sufficient assets or credit to enable it to erect the building as provided for herein. Upon the delivery of such written agreement of assumption by the new corporation, the lessee herein shall be released from all liability in connection with this lease, except any liability that shall devolve upon said lessee in his capacity as a stockholder or director of such corporation, or shall have accrued prior to such transfer.

* * * *

XXV.

LESSEE'S RIGHT TO TERMINATE

(a) If it becomes unlawful to maintain or operate a restaurant upon the demised premises, lessee may terminate this lease by written notice given to lessors promptly upon the establishment of that fact.

(b) If at any time the flow of vehicular traffic past the demised premises shall be substantially and permanently diminished as the direct result of the construction in the vicinity of the demised premises of any free-way or divided highway, or the permanent re-location, improvement, closing, or abandonment of Wilshire Boulevard or Western Avenue where the same front the demised premises, or the construction of any underpass, overpass, by-pass, tunnel, or subway at these points, except a pedestrian underpass or tunnel or tunnels, such as present school tunnels, [319] then lessee shall have the right to terminate this lease by thirty

Exhibit No. 1-A—(Continued)

days' written notice given to lessors promptly upon the establishment of that fact.

The foregoing option shall be available to lessee only if not in default hereunder.

Upon the termination of this lease as provided in this Paragraph (b), the ownership of the building constructed on said premises shall vest in the lessee, who shall be entitled to remove the same from the demised premises. If the same is not removed within thirty days after the termination of this lease, then and in that event title to said building shall revert to lessors herein.

XXVI.

LESSORS' RIGHT TO TERMINATE

Lessors shall have the right at any time during the last five years of the term of this lease of terminating the same upon thirty days' written notice to lessee of their election to terminate the lease and upon payment by lessors to lessee of the sum of Twenty-five Thousand Dollars (\$25,000.00) in cash, which said sum shall be payable at the time said notice of termination is served upon lessee.

XXVII.

OWNERSHIP OF BUILDING UPON
TERMINATION OF LEASE

Upon termination of this lease by reason of the expiration of the term hereof or by reason of the exercise of lessors' right to terminate as herein provided in Paragraph XXVI, or by any other

Exhibit No. 1-A—(Continued)

reason, title to the building erected on said property shall revert and belong to lessee, provided the lessee, at the time of such termination, is not in default in the [320] performance of any of the conditions, covenants, and provisions of this lease.

* * * *

XXXI.

HEIRS AND ASSIGNS

The covenants and conditions herein contained shall, subject to the provisions as to assignment, apply to and bind the heirs, successors, executors, administrators, and assigns of all the parties hereto; and all the parties hereto shall be jointly and severally liable hereunder.

* * * *

In Witness Whereof, the parties hereto have hereunto set their hands and seals, all as of the day and year first above written.

/s/ ROBERT ASHLEY PETTEY,

/s/ JULIA FAY PETTEY,

Trustees of the Estate of Mary Emma Pettey,
Deceased,

Lessors.

/s/ WILLIAM H. SIMON,

Lessee. [321]

Exhibit No. 1-A—(Continued)

State of California,
County of Los Angeles—ss.

On this 30th day of April, 1941, before me, Edith W. Olmstead, a Notary Public in and for said County and State, personally appeared Robert Ashley Pettey and Julia Fay Pettey, known to me to be the persons whose names are subscribed to the within instrument as Trustees of the Estate of Mary Emma Pettey, Deceased, and acknowledged to me that they executed the same as such Trustees.

(Seal) EDITH W. OLMSTEAD,
Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires July 22, 1942.

State of California,
County of Los Angeles—ss.

On this 26th day of April, 1941, before me, Dorothy Block, a Notary Public in and for said County and State, personally appeared William H. Simon, known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that he executed the same.

(Seal) DOROTHY BLOCK,
Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires December 9, 1941. [322]

EXHIBIT No. 2-B

SUPPLEMENT TO LEASE

This agreement, made and entered into this 2nd day of May, 1941, by and between Robert Ashley Pettey and Julia Fay Pettey, Trustees of the Estate of Mary Emma Pettey, Deceased, hereinafter called lessors; and William H. Simon, hereinafter called lessee;

Witnesseth:

Whereas, the parties hereto have heretofore executed that certain lease wherein and whereby lessors have leased to lessee for a period of fifteen years the following-described property, situated in the City of Los Angeles, County of Los Angeles, State of California:

Lots 1 and 2 in Block H of Westminster Place, as per map thereof recorded in the office of the County Recorder of the County of Los Angeles, State of California, in Book 9, Page 61 of Maps;

and

Whereas, said lease has not been delivered and, therefore, is not in full force and effect; and

Whereas, it is proposed to deliver said lease upon the execution of this supplemental agreement, which said supplemental agreement shall become a part of and be construed with that certain lease;

Now, therefore, in consideration of the payment of rents and performance of the covenants and

Exhibit No. 2-B—(Continued)

agreements contained in the above-mentioned lease and in this supplemental agreement, it is mutually agreed by and between the parties as follows:

(1) It is understood and agreed that the dimensions of the above-described demised premises are approximately 150 feet x 150 feet.

(2) Lessors agree, within sixty days after the [323] delivery of this lease, to remove all buildings and improvements from the demised premises and clear the same so that lessee may commence construction thereon.

When said premises have been cleared and are ready for construction lessors shall notify lessee in writing; and possession of said premises shall be deemed to have been delivered by lessors to lessee at the time said premises have been so cleared and said written notice delivered to lessee.

(3) Article V, on Page 5 of said lease, is hereby amended to read as follows:

“Anything in this lease to the contrary notwithstanding, the guaranteed minimum monthly rental due and payable pursuant to the provisions of this lease shall abate during the period the present improvements are being removed from said premises and during the period of the planning and construction of said building; provided, however, that said period of abatement shall not exceed five months from the date possession of said premises has been delivered to lessee as herein provided; and dur-

Exhibit No. 2-B—(Continued)

ing said period of abatement the following rentals shall be due and payable in lieu of said guaranteed minimum monthly rentals:

“(1) No rent shall be due and payable during the period the lessors are removing the present buildings from the premises and for a period of two months after possession of the premises has been delivered to lessee.

“(2) For the third, fourth, and fifth months after possession has been delivered to lessee, the sum of Five Hundred Dollars (\$500.00) per month shall be due and payable. Receipt of the rental for these three months is hereby acknowledged.”

(4) Article XV, of Page 14 of said lease, is hereby amended so that the first two lines of said article shall read as follows:

“Commencing with the day on which lessee starts to carry on business on the demised premises, or five months after the day possession of the premises is delivered to lessee, whichever date is the sooner”

(5) Article XXIII, on Page 20 of said lease, is hereby amended by the addition of the following paragraph: [324]

“After the above-mentioned corporation has been formed and the restaurant building constructed and erected on the demised premises, and this lease assigned to said corporation, lessors hereby agree and consent to said cor-

Exhibit No. 2-B—(Continued)

poration's sub-letting to a partnership which will operate the restaurant on the demised premises; provided, however, that said partnership shall operate said restaurant under the name of "Carpenter's" and conducts and carries on the business on the demised premises in accordance with the present method of conducting the drive-in restaurant establishments operated in the City of Los Angeles, State of California, by Harry B. Carpenter."

In Witness Whereof, the parties hereto have hereunto set their hands and seals, all as of the day and year first above written.

/s/ ROBERT ASHLEY PETTEY,

/s/ JULIA FAY PETTEY,

Trustees of the Estate of Mary
Emma Pettey, Deceased,
Lessors.

/s/ WILLIAM H. SIMON,

Lessee. [325]

EXHIBIT No. 3-C

CONSENT TO MEETING AND WAIVER OF
NOTICE THEREOF

We, the undersigned, being the persons named as directors in the Articles of Incorporation of Wilshire and Western Sandwiches, Inc., a corporation organized under the laws of the State of California, do hereby consent to the holding of the first

Exhibit No. 3-C—(Continued)

meeting of the incorporators at Room 307, 649 So. Olive Street, in the City of Los Angeles, State of California, on July 14, 1941, at the hour of 4:00 p.m., for the purpose of adopting by-laws, electing officers, and for the transaction of any other business pertaining to said corporation and its affairs which may come before said meeting; and the undersigned and each of them hereby waive written notice of the time and place of the holding of said meeting.

Los Angeles, California, July 14, 1941.

HARRY B. CARPENTER,
M. A. McDONNELL,
WM. H. SIMON,
MIKE LYMAN,
G. C. JOBSON.

[326]

MINUTES OF FIRST MEETING OF
BOARD OF DIRECTORS

Of Wilshire and Western Sandwiches, Inc., a
California Corporation

The directors named in the Articles of Incorporation of Wilshire and Western Sandwiches, Inc., a California corporation, held their first meeting at Room 307, No. 649 So. Olive Street, in the City of Los Angeles, California, on the 14th day of July, 1941, at the hour of 4:00 o'clock p.m. of said day.

Present at said meeting: Harry B. Carpenter, M. A. McDonnell, William H. Simon, Mike Lyman,

Exhibit No. 3-C—(Continued)

and G. C. Jobson, being all of the directors of said corporation named in its Articles of Incorporation.

On motion and by unanimous vote, Mr. Harry B. Carpenter was elected temporary Chairman and Mr. G. C. Jobson was elected temporary Secretary of the meeting.

The Chairman announced that the meeting was held pursuant to written Waiver of Notice thereof and Consent thereto, signed by all of the directors of the corporation named as such in the Articles of Incorporation. Such waiver and consent was presented to the meeting and upon motion made and unanimously carried, was made a part of [327] the records of the meeting, and now precedes the minutes of this meeting in the book of minutes of the corporation.

The Chairman stated that the original Articles of Incorporation had been filed in the Office of the Secretary of State of the State of California, on the 24th day of March, 1941, and that a copy thereof, certified by the Secretary of State, had been filed in the office of the County Clerk of Los Angeles County, California, on the 31st day of March, 1941, being the county in which the corporation is to have its principal office. He presented to the meeting a copy of said Articles of Incorporation, showing filings as stated, and the secretary was directed to insert said copy in the book of minutes of said corporation.

The matter of the adoption of by-laws for the

Exhibit No. 3-C—(Continued)

regulation of the affairs of the corporation was next considered. The Secretary presented to the meeting a form of by-laws, which were duly considered and discussed. On motion duly made and unanimously carried, the following resolutions were adopted, to wit:

Resolved; That the by-laws presented to this meeting and discussed thereat be, and the same hereby are adopted as and for the by-laws of this corporation.

Resolved Further; That the Secretary of this corporation be, and he hereby is authorized and directed to execute a certificate of the adoption of said by-laws and to insert said by-laws as so certified in the book of minutes of this corporation, and to see that a copy of said by-laws, similarly certified, is kept at the principal office for the transaction [328] of business of this corporation, in accordance with Section 302 of the Civil Code of the State of California.

The meeting then proceeded to the election of officers. The following were duly elected to the offices indicated after the names of each:

1. President: Mr. Harry B. Carpenter.
2. Vice-President: Mr. William H. Simon.
3. Secretary-Treasurer: Mr. Harry B. Carpenter, Jr.

Each officer so elected, being present, accepted his office, and thereafter the President presided at

Exhibit No. 3-C—(Continued)

the meeting as Chairman and the Secretary acted as Secretary of the meeting.

The Secretary presented for the approval of the meeting a proposed seal of the corporation, consisting of two concentric circles with the words, "Wilshire and Western Sandwiches, Inc., California", and the words and figures, "Incorporated March 24, 1941", in the form and figure as follows:

On motion duly made and unanimously carried, the following resolution was adopted:

Resolved; That the corporate seal, in the form, words and figures presented to this meeting, be and the same hereby is adopted as the seal of this corporation.

The Secretary presented to the meeting a proposed form of share certificate for use by the corporation. On motion [329] duly made and unanimously carried, said form of share certificate was approved and adopted, and the Secretary was instructed to insert a copy thereof in the book of minutes immediately following the minutes of the meeting.

Mr. William H. Simon, one of the original incorporators, was present at the meeting. He stated that he had acquired a lease, dated April 26, 1941, and a supplement thereto, dated May 2, 1941, from Robert Ashley Pettey and Julia Fay Pettey, trustees of the Estate of Mary Emma Pettey, deceased, hereinafter referred to as "lease", leasing to him certain real property situate at the north-

Exhibit No. 3-C—(Continued)

west corner of Wilshire Boulevard and Western Avenue, in the City of Los Angeles, County of Los Angeles, State of California, more particularly described as:

Lots 1 and 2 in Block H of Westminster Place, as per map thereof recorded in the office of the County Recorder of the County of Los Angeles, State of California, in Book 9, Page 61 of Maps.

said lease being for a period of fifteen years beginning April 30, 1941, and ending April 29, 1956, and providing for a percentage rental of six per cent of the total gross sales made in connection with the business conducted in on or from the demised premises with the provision that said rental shall not be less than \$700 each month during the term of said lease, and containing other provisions, as more fully appears by said lease; and that said lease further provides that the same may be assigned to a corporation formed in which he would be one of the incorporators, in such [330] event the corporation to accept such assignment and agree in writing to be bound by and carry out and perform all the covenants of the lease to the same extent as if the said corporation had been originally named in the lease in the place and stead of said Simon, and in such event said Simon to be released from all personal liability under the lease. Said Simon thereupon exhibited and presented said lease to the meeting. Said Simon proposed to assign said lease to this corporation, and all his

Exhibit No. 3-C—(Continued)

right, title and interest therein, upon this corporation assuming said lease and paying to him the amount of any costs and expenses which he may have incurred in acquiring said lease, and assuming his obligation for the construction of said building upon said premises. He further stated that it had been agreed among the incorporators that, in the event of the assignment of the said lease to this corporation, it would proceed with the erection of a drive-in sandwich stand and the equipment thereof and that the incorporators would purchase stock to the extent of at least \$15,000 and, thereafter, individually lend to the corporation a sufficient sum to enable it to complete the erection and construction of said drive-in sandwich stand on said premises and the equipment thereof.

Thereupon, the following resolution was unanimously adopted: [331]

“Whereas William H. Simon has offered to assign and transfer to this corporation that certain lease dated April 25, 1941, between Robert Ashley Pettey and Julia Fay Pettey, trustees of the Estate of Mary Emma Pettey, deceased, as Lessors, and William H. Simon, as Lessee, whereby the Lessors leased to the Lessee the certain premises at the northwest corner of Wilshire and Western Avenue in the City of Los Angeles, to wit:

Lots 1 and 2 in Block H of Westminster Place, as per map thereof recorded in the

Exhibit No. 3-C—(Continued)

office of the County Recorder of the County of Los Angeles, State of California, in Book 9, Page 61 of Maps.

(which said lease has been exhibited to and considered by the Board of Directors of this corporation at this meeting) upon the condition that this corporation accept the assignment of said lease and agree to be bound by and perform all of the terms and conditions thereof;

Now, Therefore, Be It Resolved that this corporation accepts said proposal and authorizes the President and the Secretary of this Corporation to execute its written acceptance of the assignment of said lease and its written agreement to be bound by and to perform all of the covenants and conditions of said lease.

Carried, all of the Directors voting "Aye".

On motion duly made and seconded and unanimously carried it was resolved that the President and Secretary of this corporation be and they are hereby authorized to make application in the name of this corporation to the Commissioner of Corporations of the State of California for a permit to issue and sell at this time to the original incorporators \$15,000 of the capital stock of this corporation, at par, for cash, and also for a permit authorizing this corporation to sell to the original incorporators all the balance of its capital stock, at

Exhibit No. 3-C—(Continued)

par, for cash, at such times as may be from time to time ordered [332] by the Board of Directors.

The President stated that it was necessary for this corporation to fix and establish a taxable year for federal and state income tax purposes. Whereupon, on motion duly made, seconded, and un-animously carried, the following resolution was adopted:

Resolved; That this corporation shall, and the Board of Directors thereof does, hereby fix the taxable year of this corporation for Federal and State income tax purposes as being from January 1st to and including December 31st of each and every calendar year, and that the first of said taxable years shall be the year 1941 and such taxable year shall end on December 31, 1941.

To provide for a depository for the funds of the corporation and to authorize certain officers to deal with the corporation funds, the following resolution was duly adopted:

Resolved; That the funds of this corporation be deposited with the Bank of America National Trust & Savings Association, Wilshire and Western Branch, 635 South Western Avenue, Los Angeles, California.

Resolved Further; That all checks and drafts shall be signed by the President, Harry B. Carpenter, or the Secretary, Harry B. Car-

Exhibit No. 3-C—(Continued)

penter, Jr., and all other instruments obligating this corporation to pay money shall be signed on behalf of this corporation by the President and Secretary, or by any two of the President, Vice-President and Secretary.

There being no further business to come before the board, on motion duly made, seconded and unanimously carried, the meeting adjourned.

HARRY B. CARPENTER, JR.,
Secretary.

Approved:

HARRY B. CARPENTER,
President. [333]

EXHIBIT No. 4-D

Before the Division of Corporations, Department
of Investment of the State of California

No.

In the Matter of

WILSHIRE & WESTERN SANDWICHES,
Inc., a corporation

Application for Leave to
Issue Capital Stock

APPLICATION FOR PERMIT

To the Honorable Commissioner of Corporations
of the State of California:

The petitioner, Wilshire and Western Sand-

Exhibit No. 4-D—(Continued)

wiches, Inc., a corporation, respectfully represents as follows:

I.

That petitioner is a corporation organized and existing under and by virtue of the laws of the State of California, having its principal place of business in the City of Los Angeles, County of Los Angeles, State of California.

II.

That its Articles of Incorporation were duly filed in the office of the Secretary of State of the State of California [334] on March 24, 1941. That a copy of said Articles of Incorporation was duly filed in the office of the County Clerk in and for the County of Los Angeles, State of California, on March 31, 1941. That a copy of said Articles of Incorporation is hereto annexed, marked Exhibit "A" and made a part of this application.

III.

That the principal office of said corporation is in the County of Los Angeles, State of California, and its principal post office address is 3180 West Sixth Street, Los Angeles, California.

IV.

That the name of its attorneys in the matter of this proceeding is Tanner, Odell & Taft, 524 Van Nuys Building, Los Angeles, California.

V.

That the active business of said corporation will be carried on by the following persons, who are officers and directors of the corporation:

Exhibit No. 4-D—(Continued)

Harry B. Carpenter, President, 625 Cumberland Road, Glendale, California.

Wm. H. Simon, Vice-President, 9515 Heather Road, Los Angeles, California. [335]

Harry B. Carpenter, Jr., Secretary-Treasurer, 1945 West Mountain Street, Glendale, California.

VI.

That the corporation has duly adopted by-laws for the government of said corporation. That a copy of said by-laws is hereto annexed, marked Exhibit "B", and made a part of this application.

VII.

That a copy of all minutes relating to or affecting the issuance of securities by the corporation, namely, a portion of the minutes of a meeting of the corporation held on the 14th day of July, 1941, is hereto annexed, marked Exhibit "C" and made a part of this application.

VIII.

That the purpose for which the corporation has been organized is to carry on and operate a drive-in sandwich restaurant and for that purpose to lease real estate or to acquire a lease thereon, and to erect thereon the necessary buildings and structures with the accessories for the establishment, carrying on and maintenance of said business and to equip the same with all the necessary equipment and paraphernalia. It is proposed to sell and issue at this time 1500 shares of the [336] common stock of the corporation for the purpose of raising money to erect a building and such other structures

Exhibit No. 4-D—(Continued)

as may be necessary for the conduct of said business and to pay the expenses of incorporation and of making this application not to exceed \$500, and to borrow from the individual stockholders or incorporators additional money sufficient to complete such buildings and equip the same and furnish it as may be needed in the conduct of the business. It is proposed also to sell additional of its stock for cash and to the incorporators if it should become necessary to do so for the purpose of completing the building or equipment or for further expanding the business or facilities thereof.

IX.

That a copy of the certificate of stock proposed to be issued by said corporation is hereto annexed, marked Exhibit "D" and made a part of this application.

X.

That it is proposed to sell 1500 shares of said stock to the particular persons hereinafter named and not to the public. That the sales of stock are to be made for cash, lawful money of the United States, to be paid into the treasury of the corporation. That no commission will be paid for the [337] sale of any of said stock and no prospectus or advertising of any kind will be used. That it is proposed to sell said stock immediately upon the issuance of a permit to issue the same.

XI.

That the names and addresses of the officers of the corporation are as follows:

Exhibit No. 4-D—(Continued)

Harry B. Carpenter, 625 Cumberland Road, Glendale, California.

Wm. H. Simon, 9515 Heather Street, Los Angeles, California.

Harry B. Carpenter, Jr., 1945 West Mountain Street, Glendale, California.

The qualifications of the officers who will have charge of the business are as follows:

Harry B. Carpenter has been engaged in the restaurant business for over thirty years and has operated as a restaurateur and in the conduct of restaurant business, both individually and in association with others during the whole of said period.

Wm. H. Simon has been engaged in the restaurant business individually and in association with others for over twenty-five years.

Harry B. Carpenter, Jr., twenty-seven years of age, has been employed by his father, Harry B. Carpenter, for approximately eight years in connection with the operation of drive-in sandwich restaurants, and has served as manager of one of [338] such establishments for said Harry B. Carpenter, Sr., for about six years and has been president of Carpenter's Sandwiches, Inc., since on or about September 1, 1937, and in active charge of the operations of the sandwich stand and restaurant conducted by said Carpenter's Sandwiches, Inc. For several years he has also had charge of accounts and bookkeeping in connection with the drive-in sandwich restaurants operated by Harry B. Carpenter.

Exhibit No. 4-D—(Continued)

XII.

No itemized account of the financial condition of said corporation is hereto attached for the reason that it has as yet no assets and no liabilities and has not done any business.

XIII.

The date upon which the corporation proposes to commence to sell its securities is within five days after the granting of this application.

XIV.

The number, kind and amount of the securities said corporation proposes to sell is as follows:

1500 shares for cash. [339]

5000 shares in such amounts and at such times thereafter as may be authorized by the Board of Directors of said corporation, the same to be sold to the said original incorporators for cash. The par value of said stock is \$10 per share and the price at which it proposes to sell its securities is the same.

Wherefore, Petitioner prays that a permit be issued authorizing the applicant to sell 1500 shares of its capital stock to: Harry B. Carpenter, M. A. McDonnell, Wm. H. Simon, Mike Lyman, G. C. Jobson, for \$15,000 cash, the same to be sold and issued to them in such proportions or amounts as they may determine, and further permitting said applicant to issue the remaining 6000 shares to said original incorporators for cash to be paid to them at the time of issuance at the full par value

Exhibit No. 4-D—(Continued)

of stock so issued, the same to be issued for cash as aforesaid from time to time as may be directed and ordered by the Board of Directors.

Very respectfully,

(Seal)

WILSHIRE AND WESTERN
SANDWICHES, INC.,

By HARRY B. CARPENTER,
President.

By HARRY B. CARPENTER, JR.
Secretary. [340]

State of California,
County of Los Angeles—ss.

Harry B. Carpenter, being duly sworn on oath deposes and says that he is the President and one of the directors of Wilshire and Western Sandwiches, Inc., a corporation, mentioned in the within application, and knows the contents thereof and that the statements therein are true.

HARRY B. CARPENTER.

Subscribed and sworn to before me this 14th day of July, 1941.

ROBERT A. ODELL,
Notary Public in and for the County of Los Angeles, State of California. [341]

EXHIBIT No. 5-E

Copy

Before The Department of Investment, Division of
Corporations of the State of California

In the matter of the application of

WILSHIRE & WESTERN SANDWICHES,
INC.,

for a permit authorizing it to sell and issue its
securities.

PERMIT

File No. 73136 LA

Receipt No. LA A7394

This permit does not constitute a recommendation or endorsement of the securities permitted to be issued, but is permissive only Wilshire and Western Sandwiches, Inc., a California corporation, is hereby authorized to sell and issue its securities as hereinbelow set forth:

1. To sell and issue to Harry B. Carpenter, M. A. McDonnell, Wm. H. Simon, Mike Lyman, and G. C. Jobson, or to any or all of them, an aggregate of not to exceed 7,500 shares, at par, for cash, lawful money of the United States, for the uses and purposes recited in its application, and so as to net applicant the full amount of the selling price thereof.

This permit is issued upon the following condition:

(a) That unless revoked, suspended, or renewed upon application filed on or before the date of expiration specified in this condition, all authority to sell and issue securities under issuance clause 1 of this permit shall terminate and expire on the 17th day of January, 1942.

Dated Los Angeles, California, July 17, 1941.

(Seal) EDWIN M. DAUGHERTY,
Commissioner of Corporations,

By /s/ RONALD H. LOENHOLM,
Deputy.

JFO'D:EM

Corp. Form A-2

[342]

EXHIBIT No. 6-F

ASSIGNMENT AND ASSUMPTION OF LEASE

This Agreement made and entered into this 14th day of July, 1941, by and between Wm. H. Simon, hereinafter referred to as "Assignor", and Wilshire and Western Sandwiches, Inc., a California Corporation, hereinafter referred to as "Assignee,"

Witnesseth:

Whereas, on or about the 2nd day of May, 1941, Assignor and Robert Ashley Pettey and Julia Fay Pettey, Trustees of the estate of Mary Emma Pettey, deceased, entered into a certain written lease agreement dated April 26, 1941 and a certain written Supplemental Lease Agreement dated May 2,

1941, wherein and whereby the said Robert Ashley Pettey and Julia Fay Pettey, as Trustees of the estate of Mary Emma Pettey, leased to Assignor for a term of fifteen (15) years, commencing on the 30th day of April, 1941, the following described premises.

Lots 1 and 2 in Block H of Westminster Place, as per map thereof recorded in the office of the County Recorder of the County of Los Angeles, State of California, in Book 9, Page 61 of Maps.

Now, Therefore, in consideration of the mutual covenants herein contained and other good and valuable consideration, the parties hereto agree as follows:

1. Assignor does by these presents grant, bargain, sell, assign, transfer, and set over unto Assignee all of the right, title and interest of Assignor in and to the above-described lease.

2. Assignee does hereby expressly accept and assume and agree to perform each, every, and all of the conditions, [343] covenants, and obligations contained in said lease to be kept and performed by the lessee therein, and does expressly agree to perform and be bound by all of the agreements, restrictions, and conditions of said lease on the part of the lessee to be kept and performed, the same as if this corporation had been originally named in said lease in the place and stead of assignor.

In Witness Whereof, assignor has hereunto set

his hand and assignee has caused this agreement to be executed by its officers thereunto duly authorized, and its corporate seal to be hereunto affixed; all as of the day and year first above written.

/s/ WM. H. SIMON,
Assignor,

WILSHIRE AND WESTERN
SANDWICHES, INC.,
a California corporation,

By HARRY B. CARPENTER,
President.

(Seal) By HARRY B. CARPENTER, JR.,
Secretary Assignee.

We hereby consent to the foregoing assignment.

Dated August 14, 1941.

/s/ ROBERT ASHLEY PETTEY,

/s/ JULIA FAY PETTEY,
Trustees of the Estate of Mary Emma Pettey, deceased. [344]

State of California,
County of Los Angeles—ss.

On this 21st day of August, 1941, before me, Alvin M. Sidman, a Notary Public in and for said County, personally appeared Wm. H. Simon,

known to me to be the person whose name is subscribed to the within instrument and acknowledged to me that he executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year in this certificate first written.

(Seal) ALVIN M. SIDMAN,
Notary Public in and for said County and State.

My Commission expires July 17, 1945.

State of California,
County of Los Angeles—ss.

On this 28 day of August, 1941, before me, Robert A. Odell, a Notary Public in and for said County, personally appeared Harry B. Carpenter, known to me to be the President, and Harry B. Carpenter, Jr., known to me to be the Secretary of Wilshire and Western Sandwiches, Inc., the corporation that executed the within instrument known to me to be the persons who executed the same on behalf of the corporation therein named, and acknowledged to me that such corporation executed the same.

Witness My Hand and Official Seal.

ROBERT A. ODELL,
Notary Public in and for said County and State.

EXHIBIT No. 7-G

Copy

LEASE

This Lease, made and entered into this 22nd day of August, 1931, by and between Edna R. Vogel as Lessor and Wilshire-Western Sandwiches, Inc., as Lessee:

Witnesseth:

That, in consideration of the payments of rents and the performance of other covenants and agreements herein provided to be performed by the Lessee, the Lessor has leased and demised unto the Lessee the premises situated in the City of and County of Los Angeles, State of California, particularly described as follows:

Lot 15 Block "H" Westminster Place, as per map thereof recorded in Book 9 Page 61 of Maps, in the office of the County Recorder of said County; said property being known as 640 South Manhattan Place;

together with all the rights, easements and appurtenances to the real property belonging and appertaining and usually had and enjoyed therewith; subject however, to the terms, conditions, exceptions, reservations and restrictions herein mentioned or contained.

The term of this lease shall be for fourteen (14) years and eight (8) months commencing on the first day of September, 1941 and ending on the 29th day of April, 1956.

Exhibit No. 7-G—(Continued)

Lessee hereby agrees to pay a rental for said premises during the entire period of this lease of Sixty (\$60) Dollars per month, payable monthly in advance on the first day of each and every calendar month of the term of this lease. In addition to said monthly rental of Sixty (\$60) Dollars, Lessee [346] hereby covenants and agrees to pay, prior to delinquency, all of the taxes, City, County or State, levied or assessed upon demised premises and upon any improvements placed thereon by Lessee and upon any personal property, furniture or equipment owned by Lessee or stored or used on the demised premises; and all lighting assessments thereon.

Compensation and Liability Insurance:

Lessee hereby agrees that it will maintain an insurance policy with a responsible company and at its own expense, insuring Lessor against all liability for damages which may be occasioned to any persons or property while on said demised premises and agrees to indemnify Lessor for any damage or liability which they may incur or from any demands or liability, causes of action or expense to which Lessor may be put by reason of any injury to persons or property resulting from the use or operation of the demised premises. Lessee also agrees to furnish Lessor a copy of said liability insurance policy.

Assignment and Sub-Letting:

Lessee may assign this lease or sub-let the whole or any part of said premises providing Lessee

Exhibit No. 7-G—(Continued)

continue to assume the same responsibility as to payment of rents and the conditions and provisions herein contained.

Covenants Against Liens:

Lessee covenants and agrees that it will not during the term hereof, permit any lien to be placed upon said premises and will hold harmless the Lessor and her property against any lien. [347]

Use of Premises:

The herein demised premises may be used by Lessee for any purpose not prohibited by governmental regulation, ordinances or laws.

Insolvency or Receivership:

If any adjudication of bankruptcy or insolvency be rendered against the Lessee or if a receiver of the business or assets of the Lessee shall be appointed, or it shall be attached, or if any sale or attempted sale of the leasehold interest hereby created shall be made under or by virtue of any execution or other judicial process, the Lessor shall have the right to immediately terminate this lease, and no person shall have the right to use, possess or occupy the said premises by virtue thereof.

Default:

In the event of default at any time by Lessee in the payment of the rent herein provided for, for more than twenty (20) days, or in the performance of any other of its agreements herein contained, or if Lessee vacate or abandon the demise premises for a period of ten (10) days, then in any or either of such events it shall be lawful for Lessor, after

Exhibit No. 7-G—(Continued)

three (3) days' notice in writing to Lessee of such default, to declare said demised term ended and to re-enter the premises or any part thereof either with or without process of law.

Possession of Premises:

Lessor hereby agrees to permit Lessee to remove the garage now on said premises in order that Lessee may begin work on its contemplated improvements on the Easterly fifty (50) feet of said premises, at any time after the execution of this lease; Lessor further agrees to remove all other [348] buildings from said premises not later than September 15, 1941.

Ownership of Building:

Upon the termination of this lease by reason of the expiration of the term hereof or by any other reason, title to the buildings erected on said property shall revert to and belong to Lessee, provided the Lessee, at the time of such termination is not in default in the performance of any of the conditions, covenants and provisions of this lease. it being understood however that if this lease is terminated for any reason at any time before April 29, 1956, said buildings are not to be removed by the Lessee without first obtaining the written consent of the Lessor. In the event of the removal of said buildings, Lessee hereby agrees to leave the lot in a level and satisfactory condition.

Exhibit No. 7-G—(Continued)

Utilities:

Lessee Further agrees to pay promptly and prior to delinquency all charges incurred by lessee in the conduct or operation of its said business on the demised premises for gas, water, electricity, telephone and all other expenses and charges it may have, and for any and all other public utilities furnished to or which may be used upon the whole or any part of the herein demised premises.

Place for Payments of Money and Notices:

All payments of rental due hereunder shall be paid to Lessor at 754 North New Hampshire Avenue, Los Angeles, California, or at such other place as Lessor may from time to time designate in writing.

Service of any notice or notices or demands required or permitted to be given hereunder shall be sufficient if delivered to Lessor personally or duly authorized representative of Lessee personally, or if sent by United States Registered [349] Mail, postage prepaid, to Lessor, addressed to 754 North New Hampshire Avenue, Los Angeles, California or elsewhere as Lessor may from time to time designate in writing, or to Lessee, addressed to the demised premises or to 3180 West 6th Street, Los Angeles, California, or elsewhere as Lessee may from time to time designate in writing.

Payment of Money:

All sums of money to be paid by Lessee hereunder shall be payable in coin or currency which

Exhibit No. 7-G—(Continued)

at the time of payment is legal tender in the United States of America for public or private debts.

Holding Over:

Any holding over after the expiration of the said term, with the consent of the Lessor, shall be construed to be a tenancy from month to month, at a minimum rental of One Hundred (\$100) Dollars a month, and shall otherwise be on the terms and conditions herein specified, so far as applicable.

Heirs and Assigns:

The covenants and conditions herein contained shall, subject to the provisions as to assignment, apply to and bind the heirs, successors, executors, administrators and assigns of all the parties hereto; and all the parties hereto shall be jointly and severally liable hereunder.

In Witness Whereof, the parties hereto have hereunto set their hands and seals, all as of the day and year first above written.

/s/ EDNA R. VOGEL,

Lessor.

WILSHIRE-WESTERN
SANDWICHES, INC.,

Lessee,

By /s/ HARRY B. CARPENTER,

President.

Corporate Seal.

Exhibit No. 7-G—(Continued)

State of California,
County of Los Angeles—ss.

On this 22nd day of August, 1941, before me, Edith W. Olmstead, a Notary Public in and for said County and State, personally appeared Edna R. Vogel, known to me to be the person whose name is subscribed to the within instrument and acknowledged to me that she executed the same.

In Witness Whereof, I have hereunto set my hand and seal the day and year in this certificate first above written.

(Seal) /s/ EDITH W. OLMSTEAD,
Notary Public in and for said County and State.

My Commission expires July 22, 1942.

State of California,
County of Los Angeles—ss.

On this 22nd day of August, 1941, before me, Edith W. Olmstead, a Notary Public in and for said County and State, personally appeared Harry B. Carpenter, known to me to be President of Wilshire-Western Sandwiches, Inc., the corporation that executed the within instrument, known to me to be the person who executed the within Instrument, on behalf of the Corporation herein named, and acknowledged to me that such Corporation executed the same.

In Witness Whereof I have hereunto set my

Exhibit No. 7-G—(Continued)

hand and affixed my official seal the day and year in this certificate first above written.

(Seal) /s/ EDITH W. OLMSTEAD,
Notary Public in and for said County and State.

My Commission expires July 22, 1942.

[Endorsed]: Filed Dec. 3, 1947. [351]

[Title of Tax Court and Cause.]

ORDER RE TRANSMISSION OF EXHIBITS
IN ORIGINAL FORM

For cause appearing of record, it is

Ordered that Joint Exhibits 8-H, 9-I and 10-J inclusive referred to in Item 6 of petitioner's designation of record be transmitted with the appeal record by the Clerk of The Tax Court of the United States to the Clerk of the U. S. Court of Appeals for the Ninth Circuit as physical documents.

/s/ BOLON B. TURNER,
Judge.

Dated Washington, D. C., October 7, 1948. [352]

[Title of Tax Court and Cause.]

ORDER RE TRANSMISSION OF EXHIBITS
IN ORIGINAL FORM

Upon consideration of the motion filed by the respondent in the above case for transmission of original exhibits to the United States Court of Appeals for the Ninth Circuit, it is

Ordered that petitioner's Exhibits 11 to 31, both inclusive, constituting part of the record on review in this proceeding, remain in the custody of the Clerk of The Tax Court of the United States until fifteen days before the cause is set for argument in the United States Court of Appeals for the Ninth Circuit, at which time, upon request of counsel for either party, the Clerk of The Tax Court shall transmit the original Exhibits 11 to 31, inclusive, to the Clerk of United States Court of Appeals for the Ninth Circuit, in physical form.

/s/ BOLON B. TURNER,
Judge.

Dated Washington, D. C., October 12, 1948. [353]

In the United States Circuit Court of Appeals
For the Ninth Circuit

Tax Court Docket No. 10638

WILSHIRE & WESTERN SANDWICHES,
INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

To the Clerk of The Tax Court:

You will please transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit copies duly certified as correct of the following documents and records in the above entitled cause in connection with the petition for review by said Circuit Court of Appeals for the Ninth Circuit heretofore filed by Wilshire & Western Sandwiches, Inc.:

1. Docket entries of the proceedings before the Tax Court.

2. Pleadings before the Tax Court:

(a) The petition including the annexed copy of the deficiency letter.

(b) The answer.

(c) The taxpayer's motion to amend the petition to conform to the proof.

(d) Amendment to the petition. [354]

(e) Answer to the amendment to the petition.

3. Findings of fact, opinion and decision of the Tax Court.

(a) Findings of fact and opinion promulgated June 29, 1948.

(b) Judgment entered on or about June 29, 1948.

4. Petition for review of the decision of the Tax Court and assignment of error, together with proof of service of notice of filing the petition for review and of service of a copy of the petition for review.

5. One copy of the transcript of the hearings had before the Tax Court at Los Angeles, California, on December 3, 4 and 12, 1947 and the deposition of Robert A. Odell, together with all stipulations of fact.

6. All exhibits filed in evidence including both those made a part of the stipulation of facts and those filed in evidence during the course of the hearing are to be transmitted to the Clerk of the Circuit Court of Appeals of the Ninth Circuit in physical form. [355]

7. This praecipe.

SWARTZ, TANNENBAUM,
ZIFFREN & STEINBERG
and JACOB SHEARER,

By /s/ JACOB SHEARER,
Attorneys for Petitioner.

Service of a copy of the within proceeding is hereby admitted this 6th day of October, 1948.

/s/ CHARLES OLIPHANT,
Chief Counsel,

Bureau of Internal Revenue.

[Endorsed]: T.C.U.S. Filed Oct. 6, 1948. [356]

The Tax Court of the United States
Washington

Docket No. 10638

WILSHIRE & WESTERN SANDWICHES,
INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CERTIFICATE

I, Victor S. Mersch, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 356, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 14th day of October, 1948.

/s/ VICTOR S. MERSCH,

Clerk, The Tax Court of the United States.

[Endorsed]: No. 12079. United States Court of Appeals for the Ninth Circuit. Wilshire & Western Sandwiches, Inc., Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed October 29, 1948.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
For the Ninth Circuit

Case No. 12079

WILSHIRE & WESTERN SANDWICHES,
INC., a corporation,

Petitioner on Review,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

STATEMENT OF POINTS UPON WHICH
PETITIONER INTENDS TO RELY

Comes now the Petitioner, Wilshire & Western Sandwiches, Inc., a corporation, and cites the following points upon which it intends to rely for reversal of the judgment of the Tax Court, Hon. Richard L. Disney, Judge:

1. The Tax Court erred in holding that the sum of Fifteen Hundred Dollars (\$1500) accrued in

the year 1942 and of One Thousand Four Hundred Forty-Three and 26/100 Dollars (\$1,443.26) accrued in the year 1943 and paid by the taxpayer as interest on loans by its shareholders, was not deductible as interest on an indebtedness.

2. The Tax Court erred in refusing to hold that said sums set forth above were interest on an indebtedness and as such were deductible from the taxpayer's gross income in determining its net income subject to taxation.

3. The Tax Court erred in determining that there was a deficiency in the taxpayer's income taxes for the taxable years 1942 and 1943.

4. The Tax Court erred in determining that there was a deficiency in the taxpayer's excess profits taxes for the taxable year 1943.

5. The Tax Court erred in determining that there was a deficiency in the taxpayer's declared value excess profits taxes for the year 1943.

The Petitioner designates the entire record as certified by the Tax Court to the Circuit Court of Appeals for the Ninth Circuit as necessary for a consideration of the points upon which it intends to rely.

Dated this day of November, 1948.

SWARTS, TANNENBAUM,
ZIFFREN & STEINBERG,
and JACOB SHEARER.

By /s/ DAVID TANNENBAUM,
Attorney for Petitioner.

[Endorsed]: Filed November 4, 1948. Paul P. O'Brien, Clerk.



No. 12079

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILSHIRE & WESTERN SANDWICHES, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF PETITIONER.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF
THE UNITED STATES.

SWARTS, TANNENBAUM, ZIFFREN & STEINBERG AND
JACOB SHEARER,

Attorneys for Petitioner.

DAVID TANNENBAUM,
JACOB SHEARER,
MITCHELL AARONSON,

Of Counsel,

650 South Spring Street,
Los Angeles 14, California.

FILED

FEB 25 1949

PAUL P. O'BRIEN,

CLERK



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No. 12079

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILSHIRE & WESTERN SANDWICHES, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF PETITIONER.

JURISDICTION.

This is an appeal from a judgment of the Tax Court of the United States entered June 29, 1948.

Within ninety days after January 31, 1946, the date of the mailing by the Commissioner of Internal Revenue of a notice of a deficiency in the petitioner's income tax, excess profits tax and declared value excess profits tax [R. pp. 8-22] the petitioner filed its Petition for Redetermination of the deficiency pursuant to Section 272(a) of the Internal Revenue Code [R. pp. 4-7]. The Tax Court of the United States has jurisdiction of such an action under the provisions of Sections 1101 and 272 of the Internal Revenue Code.

As set forth in the Petition for Review [R. pp. 42-46], the petitioner is a resident of Los Angeles County in the State of California and its address is 3180 West Sixth Street, Los Angeles 5, California [R. p. 42]. The peti-

tioner filed its income tax, excess profits tax and declared value excess profits tax returns for the taxable years 1942 and 1943 with the Collector of Internal Revenue for the Sixth District of California whose office is located within the Ninth Judicial District wherein the petitioner also resides. [R. pp. 42-43.] The United States Court of Appeals for the Ninth Circuit has jurisdiction to review the decision of the Tax Court under the provisions of Section 1141 of the Internal Revenue Code.

STATEMENT OF THE CASE.

The petitioner was incorporated on March 24, 1941, under the laws of the State of California for the purpose of engaging in the drive-in restaurant business. [F. of F., R. p. 27.] The corporation has an authorized capital stock of 7,500 shares at \$10.00 par value each. [F. of F., R. p. 27.] It kept its books and prepared its returns on the accrual basis. [F. of F., R. p. 28.] There was uncertainty at the time of incorporation as to the amount of money which would be needed by petitioner to erect the building in its business and to purchase the necessary equipment therefor, although it was estimated by three of the four incorporators of the petitioner that \$30,000.00 would probably be adequate for this purpose. [F. of F., R. pp. 28-29.] The incorporators agreed to advance amounts sufficient to open the petitioner for business and to obtain in return stock certificates of the petitioner for approximately 50% of their advances and promissory notes bearing 6% interest and payable in two years from date of issue for the remainder. [F. of F., R. pp. 28-29.]

The cost of the building and equipment proved to be far in excess of the incorporators' estimates and in order to meet the expenses, advances totaling \$55,000.00 were

made by the incorporators over the period from May to November, 1941. [F. of F., R. pp. 30-31.] The drive-in was completed and open for business on or about November 5, 1941. [F. of F., R. p. 30.]

At a meeting of the Board of Directors of the petitioner held November 13, 1941, a resolution was adopted authorizing the corporation to deliver to the incorporators promissory notes totaling \$25,000.00 maturing in two years with interest at the rate of 6% per annum payable quarterly and 3,000 shares of \$10.00 par value stock. [F. of F., R. p. 32.] The incorporators, H. B. Carpenter and M. A. McDonnell each received 1,000 shares of stock and notes in the amount of \$8,333.34 and \$8,333.33 respectively. William Simon and Mike Lyman each received 500 shares of stock and notes in the amount of \$4,166.67 and \$4,166.66 respectively. [F. of F., R. p. 32.]

Because of an oversight on the part of petitioner's accountant and bookkeeper, the notes were not entered on the books of the corporation until April of 1942, about four months after the notes were executed and delivered when another accountant was employed by the petitioner. [F. of F., R. p. 34.] The correcting entries were made immediately. [F. of F., R. pp. 34-35.] For the same reason, no interest, which according to the terms of the notes was to be paid quarterly, was accrued on the books of the corporation until early in 1943. [F. of F., R. p. 35.] Thereafter interest was accrued on the notes monthly. [F. of F., R. p. 35.] On December 1, 1943, \$3,055.86 was paid to the noteholders as interest to November 30, 1943, and like payments totaling \$682.10 were paid on March 23, 1945. [F. of F., R. p. 33.] The principal amount of the notes was paid in full by payments of \$10,000.00 each on April 21, 1943, and May 23, 1944,

and \$5,000.00 on March 23, 1945. [F. of F., R. p. 33.] All payments to holders of the notes were made in proportion to their holding of all of the notes. [F. of F., R. p. 33.]

In its returns for 1942 and 1943, the petitioner claimed \$1,500.00 and \$1,443.26 respectively as deductions for interest pursuant to the provisions of Section 23(b) of the Internal Revenue Code, on the notes which had been given to its incorporators. [F. of F., R. p. 35.] The Commissioner disallowed the deductions and determined deficiencies of \$599.87 and \$782.72 in the petitioner's income taxes for the years 1942 and 1943 respectively and determined deficiencies of \$1,797.05 in the petitioner's excess profits taxes and \$168.31 in the petitioner's declared value excess profits taxes for the year 1943. [R. pp. 8-22.]

On January 31, 1946, the Commissioner sent to the petitioner by registered mail a notice of the aforementioned deficiencies. [R. pp. 8-22.] Within ninety days thereof petitioner filed a Petition for Redetermination of the deficiency with the Tax Court of the United States [R. pp. 4-22], and on December 3, 4 and 12, 1947, a hearing was had before the said Tax Court. [R. p. 2.] On June 29, 1948, the Honorable Richard Disney, Judge, entered a Memorandum of Findings of Fact and Opinion wherein it was held that the amounts paid by the petitioner as interest on the notes held by its shareholders was not deductible by the petitioner as interest on an indebtedness in computing its net income subject to taxation. [R. pp. 27-41.]

The sole question presented on this appeal is whether or not the amounts payable by the petitioner in the years 1942 and 1943 to the holders of its notes was "interest

on an indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code and consequently deductible by the petitioner in computing its net income subject to taxation.

SPECIFICATIONS OF ERRORS.

1. The Tax Court erred in holding that the sum of fifteen hundred dollars (\$1,500.00) accrued in the year 1942 and of one thousand four hundred forty three dollars and twenty six cents (\$1,443.26) accrued in the year 1943 and paid by the taxpayer as interest on loans by its shareholders, was not deductible as interest on an indebtedness.

2. The Tax Court erred in refusing to hold that said sums mentioned above were interest on an indebtedness and as such were deductible from the taxpayer's gross income in determining its net income subject to taxation.

3. The Tax Court erred in determining that there was a deficiency in the taxpayer's income taxes for the taxable years 1942 and 1943.

4. The Tax Court erred in determining that there was a deficiency in the taxpayer's excess profits tax for the taxable year 1943.

5. The Tax Court erred in determining that there was a deficiency in the taxpayer's declared value excess profits taxes for the year 1943.

6. The Tax Court erred in making the following findings of fact which findings are not supported by the evidence:

a. "The incorporators of petitioner made the following payments, totaling \$55,000, to petitioner in 1941 under the plan previously adopted by them.

	MCDONNELL	SIMON	LYMAN CARPENTER
May	\$ 3,333.33		
June		\$1,666.67	\$1,666.66 \$3,333.34
August		2,500.00	2,500.00
September	5,000.00		5,000.00
October		2,500.00	2,500.00
Nov. 13		2,500.00	2,500.00
Nov. 19	10,000.00		5,000.00"
[R. p. 30.]			

The \$5,000.00 payments by Carpenter which the court finds to have been made in September and on November 19, 1941, were in fact made on October 30, 1941, and November 13, 1941.

b. "Simon expected the notes to be paid out of current earnings . . ." [F. of F., R. p. 32.]

The record clearly shows that Simon expected the notes to be paid in any event.

SUMMARY OF THE ARGUMENT.

I. INTRODUCTORY.

The sole point of disagreement is whether the notes issued by the petitioner constitute an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. This in turn depends upon the intent of the parties involved.

II. FINDINGS OF FACT.

A. The formal findings of fact made by the trial court are correct with two exceptions. The two excepted findings are unsupported by the evidence.

B. The Tax Court's conclusion of law is inconsistent with its findings of fact because the findings competently made compel the conclusion that the interest herein involved is deductible in computing the petitioner's net income subject to tax. The court expressly found all of the elements necessary to constitute an indebtedness, to wit: an intent to loan and a meeting of the minds, a transfer of the consideration and a promise to repay evidenced by negotiable promissory notes.

III.

An analysis of the court's opinion and that factors considered therein demonstrates that there is no basis in law or in fact for the decision of the Tax Court denying the petitioner the deduction for interest accrued in the taxable years involved.

There is no rule of law which excludes from the scope of Section 23(b) of the Internal Revenue Code an indebtedness created under the circumstances existing in the case at bar, nor do such circumstances justify an inference that the notes executed and delivered by petitioner were not genuine.

IV.

Should this court be of the opinion that the Tax Court drew the ultimate inference which supports its decision, it nevertheless remains free to draw those ultimate inferences and conclusions which in its opinion the findings of the Tax Court reasonably induce.

ARGUMENT.

I.

Introductory.

The single issue in this case is whether petitioner was entitled to a deduction for interest in the years involved. The sole point of disagreement between the parties is whether the notes issued to petitioner's stockholders constituted an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code or whether they constituted investments in and contributions to capital. No question is raised as to the amounts involved or the proper accrual of interest if an indebtedness existed.

"Indebtedness," under the Revenue Act has been defined as an "unconditional and legally enforceable obligation for the payment of money." (*Autenreith v. Commissioner*, 115 F. (2d) 856 at 858 (C. C. A. 3rd 1940); see also *Commissioner v. Park*, 113 F. (2d) 352 (C. C. A. 3rd 1940); *Gilman v. Commissioner*, 53 F. (2d) 47 (C. C. A. 8th 1931).)

The question then resolves itself to a simple question of fact: Was there an unconditional and legally enforceable obligation for the payment of money on the part of the taxpayer in favor of the incorporators? If there was, the moneys accrued and paid for the use of the principal moneys are clearly deductible. (*Deputy v. du Pont*, 308 U. S. 488, 84 L. Ed. 416 (1940); *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 76 L. Ed. 484 (1932).) Or stated another way, were the promissory notes issued to the incorporators genuine, evidencing legal obligations of the petitioner? (*Toledo Blade Co.*, 11 T. C. 128 (1948).)

Whether or not there was an unconditional and legally enforceable obligation for the payment of money by peti-

tioner to the individuals depends solely upon the intent of the parties involved. (*Van Clief v. Helvering*, 135 F. 2d 254 (App. D. C. 1943); *Edward Katzinger Co.*, 44 B. T. A. 533 (1941); see also *Daniel Gimbel*, 36 B. T. A. 539 (1937); *Bernuth-Lembcke Co.*, 17 B. T. A. 599 (1929); *William D. P. Jarvis*, 43 B. T. A. 439 (1941), affirmed 123 F. (2d) 742 (C. C. A. 4th 1942).)

In the *Van Clief* case, *supra*, the taxpayer was the sole stockholder of a corporation and the issue was whether or not he was entitled to a loss by reason of the fact that the stock had become worthless in the taxable year 1937. This in turn depended upon whether or not advances by the stockholder of approximately \$97,000.00 constituted loans to the corporation or capital contributions. If these advances were held to be loans, the corporate liabilities at the close of the taxable year in question exceeded the fair market value of the corporate assets, indicating, as the court pointed out, that the stock was worthless. The Board of Tax Appeals held that the advances constituted capital contributions and in reversing the judgment of the board, the Circuit Court of Appeals resolved the question to one of intent, in adopting, at page 256, the following language of the *Katzinger* case, *supra*:

“Advances are an additional contribution of capital if they are intended to enlarge the stock investment but not if they are intended as a loan . . . Here the parties intended the advances as loans.”

It follows then that once the intent of the parties here involved is determined no difficulty remains as to the proper conclusion. If the parties genuinely intended to make loans, the interest in question is deductible; if rather they intended to make capital contributions no deduction for interest is permissible.

II.

Findings of Fact.

A. The formal Findings of Fact Made by the Trial Court Are Correct With Two Exceptions. The Two Excepted Findings Are Unsupported by the Evidence.

The trial court made findings of fact, and, with two important exceptions, petitioner is prepared to accept the correctness but not the materiality of the formal findings of fact labeled as such by the court, but not necessarily of facts recited in the opinion or of the conclusion reached by the court. As to these two exceptions, there is no evidence to support the facts as formally found but on the contrary, in each case, ample uncontradicted evidence to require a contrary finding.

The first such exception relates to the alleged payment of \$5,000.00 by Carpenter on November 19, 1941. [F. of F., R. p. 30.]

The second such exception relates to the finding [F. of F., R. pp. 32-33] that Simon *expected* the notes to be paid out of current earnings. (Italics ours.)

As to the first exception, the stipulation of facts [R. p. 258], made a part of the Tax Court's findings by reference, shows such payment was in fact made on November 13, 1941.

As to the second such exception, the only evidence relating to Simon's expectancy or thoughts concerning repayment appears at pages 65-66, 72 and 84-86 of the Record. In the first instance, in referring to the note, Simon testified that it was to be paid back as a loan. [Tr., R. p. 65.] No suggestion is there made of earnings or lack of earnings. In the second relevant portion of his testimony, he stated unequivocally that he expected the

note would be repaid and that he thought repayment would be made within two years. Here again, there is no suggestion of earnings or lack of earnings. The third discussion took place on cross-examination. [Tr., R. pp. 84-86.] In response to a question as to why he took promissory notes for part of his advances to petitioner, Simon pointed out, among other reasons, that, "I could get my money back faster even if the place wasn't a success. I didn't have to wait for dividends to be earned to get my money back that way [that is by way of a loan] I could get it back out of depreciation." Then followed a colloquy in which the witness Simon attempted to explain to respondent's counsel how he could get his loan repaid out of "depreciation" even if petitioner had no profits. [Tr., R. pp. 83-86.]

"Q. Now, Mr. Simon, the stipulation shows that between June 9, 1941, and November 13, 1941, that you and Mr. Lyman had advanced certain money to the corporation. Now, will you please explain to the Court why it is that in return for the money advanced by you you took capital stock for only half the amount and instruments in the form of promissory notes for the other half?

A. At the start of this particular proposition, when we had an informal meeting, it was agreed at that time that we would invest 50 per cent and take 50 per cent in notes as loans. As I testified earlier, I didn't want to freeze too much money in that particular unit. I had other commitments and I didn't want to come in there just as a stockholder, I wanted to come in there partially as a stockholder and partially as a creditor. One, I could get my money back faster even if the place wasn't a success. I didn't have to wait for dividends to be earned to get my

money back that way. I could get it back out of the depreciation.

No. 2, if the place would fail, I became a common creditor.

Q. What do you mean by getting your money out of depreciation?

A. As a loan, when it was set up as a loan, the place didn't have to make a loan—money to meet the loan every month and they depreciate the place over a 10-year period. If the place didn't make money there was enough money from depreciation to pay back those loans.

Q. Do you mean the company set up a cash reserve each month for depreciation?

A. Every corporation depreciates their investment.

Q. Did this corporation actually set aside and earmark cash money for depreciation?

A. According to the law, as I understand it, the tax law, you can depreciate 90 per cent of your investment to be depreciated over a period of 10 years. If you have a 10-year lease you can depreciate it over a period of 10 years. You can depreciate that monthly.

Q. How was that going to return your cash money to you, is what I don't understand, Mr. Simon.

A. Well, as the investment is depreciated that money accumulates.

Q. How did you expect to be repaid for these loans, except out of the current earnings of the business?

A. You don't have to have current earnings to be paid back on a loan.

Q. How would the corporation pay you back on the loan if it did not make any money?

A. You have a depreciation account they could use. You are depreciating your investment.

Q. What was the cost of the building? I believe the stipulation shows that. \$40,489.68. Suppose the corporation didn't make sufficient money to set up a depreciation reserve, how then did you expect to get the return of cash money from your loan?

A. You mean if they lost money?

Q. Yes.

A. If they lost beyond their depreciation account, well, I would just have to come in as a creditor.

Q. In other words, this corporation, you had to realize this corporation had to make money before you could expect the payment back of your loan?

A. No, I didn't realize that. I don't know that. I don't think that is a bit necessary.

Q. Well, suppose the corporation hadn't made any money.

A. And if they didn't lose any money?

Q. Suppose they didn't make any money and actually lost money.

A. Well, that would be too bad. I would lose my money.

Q. In other words, you knew that your loan was just as good as the company's ability to make money, is that right?

A. That is right."

It will be observed that throughout this testimony Simon repeats over and over again his disbelief of the fact that it was necessary that the corporation earn a *profit* before it could repay his loan. Finally came the, "that is right" answer. It is startling enough that neither respondent's counsel, nor apparently the trial court, could recognize the correctness of the witness' contention that a corporation need not make a profit to repay its debts. Petitioner sub-

mits that it is actually fantastic that, upon the basis of the above quoted testimony, anyone could conclude as a matter of fact that Simon believed, whether rightly or wrongly, that it was necessary for petitioner to earn a net profit before his loan could be repaid.

This question of finding of fact relates solely to Simon's intent, and since the only other evidence relating to his intent was simply repetitive, it is submitted that the court erred in finding that Simon's intent was to look only to the current earnings of petitioner. The court had no alternative but to find that Simon's intent was to be repaid, even if petitioner had no earnings. In *Foran v. Commissioner*, 165 F. (2d) 705 (C. C. A. 5th 1948), the issue was the intent of the taxpayer in respect to certain property, that is, whether he intended to hold the property for reinvestment or for sale. The taxpayer's testimony as to his intent was the only evidence before the court and the Tax Court held that the properties in controversy were held for sale by the taxpayer. In reversing the decision of the Tax Court, the Circuit Court, distinguishing *Greene v. Commissioner*, 141 F. (2d) 645 (C. C. A. 5th 1944), pointed out at page 707 that:

"Here there is direct and positive evidence from the witness who best knows, that this property was for eighteen months being held as an investment and not held for sale to customers. His testimony is consistent with every proven fact. He gives a credible reason why it was not for sale and why finally in 1941 he didn't sell it. We think the court's refusal to follow the sworn testimony is contrary to law and requires the setting aside of its fact finding as it would that of a jury,"

citing *Pennsylvania Railroad Co. v. Chamberlain*, 288 U. S. 333, 77 L. Ed. 819 (1933) at page 340. Here the tes-

timony of Simon is not only consistent with every proven fact but is further consistent with the rule of law, of which he was patently aware, that a creditor may look to a debtor's assets for repayment, without regard to current earnings of the debtor.

B. The Tax Court's Conclusion of Law Is Inconsistent With Its Findings of Fact Because the Findings Competently Made Compel the Conclusion That the Interest Herein Involved Is Deductible in Computing the Petitioner's Net Income Subject to Tax.

The facts as found, with the two exceptions specified, not only compel the conclusion that an indebtedness existed, evidenced by genuine promissory notes, but actually expresses that conclusion. In its findings of fact, the Trial Court enumerated many facts incidental to the background of petitioner and to its financing but made but four findings of fact which themselves expressed the actual existence or non-existence of an indebtedness. These four findings are as follows:

1. "The original intention was to make advances totaling \$30,000.00 for stock and *loans* on an equal basis." [F. of F., R. p. 28.] (*Italics ours.*)

2. "The incorporators of petitioner made the following payments, totaling \$55,000.00 to petitioner in 1941 *under the plan previously adopted by them.*

	<u>McDonnell</u>	<u>Simon</u>	<u>Lyman</u>	<u>Carpenter</u>
May	\$ 3,333.33	\$	\$	\$
June		1,666.67	1,666.66	3,333.34
August		2,500.00	2,500.00	
September	5,000.00			
October 30		2,500.00	2,500.00	5,000.00
*November 13		2,500.00	2,500.00	5,000.00
November 19	10,000.00			"

*Corrected pursuant to stipulation.

“At the time the advances prior to November were made, the individuals *intended* that stock would be issued for one-half thereof and *notes for the remainder.*” [F. of F., R. p. 30.] (Italics ours.)

3. “At a meeting of the Board of Directors of petitioner, the membership of which included the four incorporators, on November 13, 1941, a resolution was adopted, in accordance with an agreement reached at an informal meeting the previous day, to issue to the incorporators for advances made by them promissory notes, totaling \$25,000, maturing in two years with interest at the rate of six per cent 6% per annum, payable quarterly, and stock totaling \$30,000, as follows:

	<u>Carpenter</u>	<u>McDonnell</u>	<u>Simon</u>	<u>Lyman</u>
Stock	\$10,000.00	\$10,000.00	\$5,000.00	\$5,000.00
Notes	8,333.34	8,333.33	4,166.67	4,166.66

[F. of F., R. p. 32.]

4. “The stock and notes authorized by the resolution were issued under date of November 13, 1941, and were delivered by December 5, 1941. In case of default in the payment of interest, the notes were to be immediately due and payable at the option of the holder.” [F. of F., R. p. 32.]

Although other findings of fact related to the reasons the creditors made their loan, the circumstances under which they made it, the payment thereof and other facts incidental to the loans, the foregoing, without more, represents the complete lending transaction. This was comprised of:

First—the original executory contract to loan one-half of \$30,000.00;

Second—pursuant to that contract, the actual loan of \$15,000.00 plus an additional loan of \$12,500.00;

Third—the agreement to take payment of \$2,500.00 of the loans in stock; and

Fourth—the authorization, execution and delivery of the promissory notes evidencing the balance of the indebtedness of \$25,000.00 created by the performance of the lenders pursuant to their contract to lend.

The weight of the evidence justifies and requires the court's conclusion and description of the ultimate transaction, as immediately above set forth. The witness, Simon, stated unequivocally that it was his intent to lend the corporation \$4,166.67 [Tr., R. pp. 65, 66], and enumerated at some length the reasons that he and his brother, Lyman, insisted upon lending a portion of the advances to the corporation as distinguished from purchasing stock in the full amount of their advances. He wanted to hedge upon his investment by coming in as a common creditor in the event the corporation became insolvent [Tr., R. p. 61]; because of other money commitments which he had, he did not wish to freeze all of his available funds in one unit [Tr., R. pp. 64, 84]; he had in mind that even if the company did not make a profit, he might still receive repayment of his loan out of depreciation [Tr., R. p. 64] and because he and his brother were minority stockholders, he did not wish to depend upon the other stockholders for the declaration of a dividend [Tr., R. pp. 64, 84] but rather wished to be in a position where he had the right to demand repayment.

The witness, Carpenter, testified that he considered himself a lender to the corporation. [Tr., R. p. 122.] He gave as his reasons for making a loan his desire to come in as a creditor for part of the advances in the event the business failed [Tr., R. p. 121] and his desire to be in a position to demand repayment of the loan because he

was a minority stockholder and did not wish to be in a position where he had to rely upon the others for a dividend. [Tr., R. p. 122.]

Both of these witnesses testified concerning an informal meeting wherein they and the other stockholders agreed to lend one-half of the funds which might be necessary to be paid in to the corporation [Tr., R. pp. 63, 120] although the several stockholders had different estimates of how much would ultimately be necessary to advance. [Tr., R. p. 119.] The individuals advised their attorney of their intent to make loans to petitioner as well as to purchase its stock. [Dep., R. p. 251.] They further expressed that intent to the Commission of Corporations of the State of California in petitioner's application for a permit to issue its stock in which it advised said Commissioner of its proposal to sell \$15,000.00 worth of shares to the incorporators, to borrow additional monies from said individuals and if necessary, to sell additional stock to said individuals. [Ex. 4-D, R. p. 301.] Nothing appears in the record of sufficient force to impeach this sworn testimony of the parties as to their intention in making the advances. To this the findings of the court set forth above attest.

The court having thus found that the petitioner had issued and delivered genuine promissory notes evidencing its indebtedness, it follows that interest paid or accrued upon that indebtedness is deductible under the provisions of Section 23(b) of the Internal Revenue Code.

III.

An Analysis of the Court's Opinion and the Factors Considered Therein Demonstrates That There Is No Basis in Law or in Fact for the Decision of the Tax Court Denying the Petitioner a Deduction for Interest Accrued in the Taxable Years Involved.

In its opinion, as distinguished from its findings of fact, the trial court gave several reasons justifying its conclusions that the interest herein involved is not interest upon an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. The Tax Court's conclusion can only have been reached by the application of a rule or rules of law to the facts as found or by drawing inferences from such facts to reach an ultimate conclusion of fact that loans had not been intended.

The court did not, of course, expressly make such an ultimate conclusion of fact. Had it done so, there would have been two inconsistent findings, for such a conclusion is inconsistent with the finding of fact, expressly made, that the parties did intend to make loans. For the purpose of analyzing the opinion itself, however, this inconsistency will be disregarded in order to ascertain whether, in any event, such a conclusion has support in the record or may be justifiably inferred. It is submitted that there is no rule or rules of law which, applied to the facts, compel or justify the Tax Court's decision. Nor does any fact or group of facts found by the Tax Court justify drawing an inference that the parties did not intend to make loans. Petitioner proposes to examine factors

looked to by the trial court in its opinion to determine whether any rule of law exists which, if applied to one or more of such facts, will result in reaching the Tax Court's conclusion, and to determine whether in the face of overwhelming evidence to the contrary any of these facts give rise to a justifiable inference that loans were not intended by the parties.

These factors are as follows:

1. The proportion regarded as a loan by each stockholder was in direct proportion to his stockholding. [Op., R. p. 37.]

2. "The general plan was decided on prior to any business activity of petitioner and was intended to meet capital outlays which are usually paid out of invested capital and/or secured indebtedness." [Op., R. p. 36.]

3. The absence of evidence that the incorporators were lenders of money. [Op., R. pp. 36, 37.]

4. The assertion that "the advances here have few of the usual characteristics of commercial loans entered into in arms length transactions." [Op., R. p. 37.]

5. The asserted expectation of the parties with respect to the payment at maturity. [Op., R. p. 39.]

6. The treatment of the notes on the books. [Op., R. pp. 38, 39.]

They will be examined in the order petitioner considers logical, without regard to the order of their discussion in the opinion.

1. The Proportion Regarded as a Loan by Each Stockholder Was in Direct Proportion to His Stockholding. [Op., R. pp. 37, 39.]

(a) AS A RULE OF LAW.

Though an indebtedness be owed by a corporation to its creditors-stockholders in proportion to their stockholding, it is nevertheless an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code and interest payable thereon is an allowable deduction from gross income. (*John Kelly Co.*, 1 T. C. 457, affirmed 326 U. S. 521, 87 L. Ed. 278 (1946); *Commissioner v. O. P. P. Holding Corporation*, 76 F. (2d) 11 (C. C. A. 2d, 1935); *Toledo Blade Co.*, *supra*, 11 T. C. 128; *Cleveland Adolph Mayer Realty Corp.*, 6 T. C. 730 (1946) (reversed in part on other grounds 160 F. (2d) 1012 (C. C. A. 6th, 1947)); *Clyde Bacon, Inc.*, 4 T. C. 1107 (1945).)

In the case of *Janeway v. Commissioner*, 2 T. C. 197 (1943), the Tax Court in its opinion (written by the author of the opinion in the instant case) used unfortunate language at page 202* which seemed to suggest that it was asserting a contrary rule of law. This language seems to state that as a matter of law, if the effect of both the lending and investing transactions are to give to the creditors, in their capacity of stockholders, proprietary interest in proportion to their loans, then the loans must be treated as stock investments regardless of intent. If the Tax Court, in that case, intended to express such a rule of law, its conclusion was rejected by the Supreme Court in *John Kelly Co. v. Commissioner*, 326 U. S. 521, 90 L. Ed. 278 (1946) and by the Tax Court itself in *Toledo Blade Co.*, *Cleveland Adolph Mayer Realty Corp.* and

*See Appendix.

Clyde Bacon, Inc. cases, *supra*, where the loans were all recognized as loans in spite of the proportionate proprietary interests.

(b) AS A QUESTION OF FACT.

The proportionate stock holdings and the lack of need to acquire additional proprietary interests do not justify an inference that the notes in question were not genuine. In the *Toledo Blade* case, *supra*, where one stockholder owned all of the stock of the taxpayer, the full Tax Court, without dissent, summarily disposed of the Commissioner's contention that the transaction was a sham, a contention that could have rested only upon an inference drawn from the circumstance that there was but a single stockholder.

The facts involved in the present case are considerably stronger for the taxpayer. There, at the time of the issuance of the debentures, the capital represented by the debentures was already invested in the business, and for the most part invested in fixed assets which could not be readily extricated from the risks of the business. No apparent business purpose was shown for the conversion of stock into debentures but the court pointedly refused to draw any inferences from that factor. In the instant case, several credible business reasons were present in the minds of persons before they advanced their funds and at a time when they were entirely free to enter into such contract as they chose, or for that matter to refuse to enter into any contract unless entirely satisfactory to them. Yet the *Toledo* decision rendered several months after its decision in the instant case was reviewed by and reflected the opinion of the entire tax court, without a dissent on this issue.

Nor did the tax court attempt to draw any such inference in the *Cleveland Adolph Mayer* case, *supra*. There again, the facts were much more open to such an inference than in the instant case. There as here the stock was originally owned (and there as well in the tax year in question) in proportion to the ownership of debentures. Reconversion took place so that there too the recipients of the debentures already had their money held by the corporation as capital stock. Moreover, as a result of the conversion the total capital stock issued was \$600.00 as compared to debenture bonds in the sum of \$210,000.00. Substantially, all of this \$210,600.00 was represented by real estate and as in the *Toledo Blade* case was represented by assets less liquid than in the instant case. In addition, there was some problem as to whether or not the maturity date of the debentures could not be postponed by action of persons other than the holders thereof. Nevertheless, the court refused to draw the inference which the trial court here has apparently drawn.

Again in the *Clyde Bacon, Inc.* case, *supra*, the facts there are patently more susceptible of an inference such as drawn by the court in the instant case. There the taxpayer corporation was the successor of a corporation solely owned by the stockholders of the taxpayer corporation. In exchange for all of the stock of the predecessor corporation as well as other assets of the stockholders, all of which was alleged to have an actual value of \$300,000.00, taxpayer corporation issued to the stockholders \$30,000.00 worth of its capital stock and \$270,000.00 of its debenture certificates all in proportion to the stock ownership of both the predecessor and the taxpayer corporations. The debentures provided that if the "cash position" of the taxpayer corporation did not warrant pay-

ment of interest, it might postpone such payment for four years, without the consent of the debenture holders. The rights of the debenture holders were subordinated to those of all creditors. Notwithstanding these factors, the court not only refused to draw an inference that the stockholders there did not intend to make a loan but on the contrary reconfirmed the right of the parties to enter into the contract, in the following language (at page 1116):

“At the formation of the corporation there was no obligation on the petitioner to issue any definite amount of stock in exchange for the assets received. It had the privilege of determining the character and amounts of its securities so exchanged if they were satisfactory to the recipient. The petitioner had the right to replace the stock interest with an evidence of indebtedness, if it so desired.”

That it does not follow that proportionate loans by stockholders is inconsistent with an intent to loan rather than to invest is apparent from *John Kelly Co. v. Commissioner, supra*, 326 U. S. 521, 90 L. Ed. 278 (1946). There Mr. Justice Reed, in pointing out the difference between “the wholly useless temporary compliance with the statutory literalness” involved in *Gregory v. Helvering*, 293 U. S. 465, 79 L. Ed. 596 (1935) and the two cases before it, refers to the “demonstrated possibility of sale by the holders of the obligations to persons other than stockholders . . .” as proof of the fact that even though the stock and the note were held in equal proportions by the shareholders, there is a substantial difference in their rights as shareholders and as creditors. It is interesting to note too that during the taxable years here involved, the stock of petitioner was not held in the exact

proportion of the loans of the individuals. As a matter of fact, in November or December of 1941, 100 shares of stock were transferred by Simon and Lyman to one Joe Lardemer [R. pp. 70-71, 242] who was never a creditor of the corporation. Thus the "demonstrated possibility" to which Mr. Justice Reed referred became an actuality in the instant case. When payments, whether by way of principal or interest, were made upon the notes, Mr. Lardemer did not participate. Thus not only can no inference be drawn, as was apparently done by trial court, but the facts from which the trial court attempted to draw such an inference were not correct.

2. **"The General Plan Was Decided on Prior to Any Business Activity of Petitioner and Was Intended to Meet Capital Outlays Which Are Usually Paid Out of Invested Capital and/or Secured Indebtedness."** [Op., R. p. 36.]

(a) AS A RULE OF LAW.

Taxpayer knows of no rule of law which precludes a genuine indebtedness from being incurred for the purpose of obtaining a portion of the original sums necessary to commence business. See:

Bailey v. Clark, 88 U. S. (21 Wall.) 286, 22 L. Ed. 651 (1876).

(b) AS A QUESTION OF FACT.

The factor here involved supports rather than discredits the *bona fides* of the plan. The interested parties could not conceivably foretell every development that might arise or predict to the last penny the amount of money which would be needed before the business could begin its operations. Accordingly, instead of contracting

to lend a specified amount and to purchase stock in a particular amount, they contracted by formula or percentages, a method frequently used in the conduct of business affairs. The court assumes that generally all monies used for what it calls capital "outlays" are usually paid out of invested capital or secured indebtedness or both. (Cf. *John Kelly Co. v. Commissioner*, *supra*, 326 U. S. 521, 90 L. Ed. 279 (1946); *Cleveland Adolph Mayer Co.*, *supra*, 6 T. C. 730 (1946) and *Toledo Blade Co.*, *supra*, 11 T. C. 128 (1948).) Petitioner submits that such an assumption is unwarranted. If it too is permitted to indulge in the use of "common knowledge" or what "usually" happens, petitioner suggests that the bulk of small business commenced in this country are commenced in part with ordinary unsecured bank loans.

Even granting *arguendo* the court's assumption is warranted, that fact nevertheless does not give rise to an inference that the parties did not intend to make genuine loans. True an inference that loans are intended might reasonably be drawn where parties insist upon and obtain security for loans made to a corporation to meet "capital outlay." The converse is not necessarily true and it would certainly be a *non sequitur* to say, as the court has in effect here said, that because such security is not obtained we may infer an intention to contribute to capital from the bare circumstances that the funds obtained are to be used to meet "capital outlay."

3. The Absence of Evidence That the Incorporators Were Lenders of Money. [Op., R. pp. 36-37.]

(a) AS A RULE OF LAW.

It is not necessary that persons who loan money in specific instances be generally engaged in the business of lending money before the loans which they do make may be treated as indebtedness within the provisions of Section 23(b) of the Internal Revenue Code. In the *Toledo Blade Co.* case, *supra*, the lender was a corporation owning stock of newspaper corporations and there was no evidence in that case that that stockholder was a lender of money; nor did such evidence appear concerning the stockholders in the cases of *John Kelly Co.*, *supra*; *Cleveland Adolph Mayer Realty Corp.*, *supra*, or *Commissioner v. O. P. P. Holding Corporation*, *supra*.

(b) AS A QUESTION OF FACT.

Presumably, the court refers to this factor upon the theory that had the incorporators been in the business of lending money, it would have been prepared to infer that any loan which they made was genuine. However, the court apparently is prepared to make a converse inference; that is, that since they were not in such a business it infers that any loan which they may have made is not genuine. Such a process of reasoning might be valid if it were a rarity for persons not in the business of lending money to make loans. But we need go no further than the Tax Court's own decisions relating to non-business bad debts to realize that non-business debts are created,

bona fide, every day and in numberless instances. As the court itself points out, these very stockholders loaned an additional \$10,000.00 in February of 1942, and no suggestion was made that this was a capital contribution and not a loan. Neither the court nor respondent suggests that for excess profits tax purposes that amount should be treated as invested capital rather than borrowed capital. Yet there was no evidence between May, 1941, and February, 1942, that the stockholders had entered the business of being lenders of money.

4. **The Assertion That “the Advances Here Have Few of the Usual Characteristics of Commercial Loans Entered into in Arms Length Transactions.” [Op., R. p. 37.]**

(a) AS A RULE OF LAW.

The indebtedness referred to in Section 23(b) of the Internal Revenue Code does not distinguish between one with usual, as opposed to one with unusual characteristics. True it is, that regardless of the name given an instrument evidencing an obligation, if it has legal attributes of such a nature placing it without the legal definition of “indebtedness,” such an obligation would not qualify as an indebtedness for the purposes of Section 23(b) or for any other purpose. (*Cf. 1432 Broadway Corporation*, 4 T. C. 1158 (1945).) But if there be an indebtedness within the meaning of that term as defined above, then interest paid or accrued thereon is deductible under the plain language of the statute. (*Cf. Old Colony Railroad Company v. Commissioner*, 284 U. S. 552, 76 L. Ed. 484 (1932).)

(b) AS A QUESTION OF FACT.

It follows then that this alleged factor of unusualness can be material only for the purpose of imputing a lack of genuineness to the notes, which themselves were ordinary promissory notes in usual form. In justifying its statement concerning the unusual characteristics, the court looked to four attributes which it considered unusual. The first was that,

“All of the amounts were paid in to provide petitioner with funds to start business, hence all of it was working capital.” [Op., R. p. 37.]

The second so-called unusual attribute was asserted to be the fact that,

“The amount of \$55,000.00 was required to place the restaurant in condition to commence business, yet there was no agreement to advance the final \$30,000.00 paid in until November 12, 1941, a week after the restaurant opened for business.” [Op., R. p. 37.]

The third unusual attribute asserted by the court was the fact that,

“. . . until then [November 12, 1941] no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans.” [Op., R. p. 37.]

The fourth unusual attribute mentioned by the court was the fact that,

“. . . no interest . . . was incurred by petitioner prior to November 13, 1941. In the meantime there was no agreement on when interest would start, the rate of interest or an agreement with petitioner on when the loans would mature. . . .” [Op., R. p. 38.]

The court in its opinion, does not assert what are all of the usual characteristics of commercial loans entered into in arm's length transactions. Petitioner submits, nowever, that as a matter of common knowledge, almost all, if not all of the usual characteristics of customary unsecured arm's length commercial loans are the following: the passing of money or credit from the lender to the borrower; the exaction by the lender from the borrower of a promise to repay; the fixing of a date certain for the repayment; the exaction of a promise from the borrower to pay interest to the lender; and the reduction of the borrower's promises to writing, frequently in the form of a promissory note or other negotiable instrument. All of the foregoing characteristics are present in this case.

It is apparent then that the court was not really concerned with the absence in this transaction of those essential characteristics which usually comprise all of the characteristics of a commercial loan, but was concerned rather with the additional presence of the four attributes quoted above. Accordingly, the problem in connection with the so-called unusual situation resolves itself to whether these four attributes, or any of them, justify an inference that the notes were a sham, and that the stockholders did not intend to lend money to petitioner.

As to the first attribute, that

“All of the amounts were paid in to provide petitioner with funds to start business, hence all of it was working capital.” [Op., R. p. 37.]

it should be observed that the court is really making two inferences. The unquestioned fact in the record is that the money was used to assist petitioner to start business.

The court first infers that this in itself is a departure from the normal. It then infers, because of the existence of such inferred departure, that the notes were not genuine and that the stockholders are not telling the truth when they expressed their intention to make a loan to petitioner.

Petitioner submits that neither inference is justified. There is of course no evidence in the record which even suggests that ordinary commercial loans are not frequently made to assist a debtor to start business. Therefore, in considering this attribute to be unusual the trial court is drawing upon what it believes to be a matter of common knowledge. Common knowledge of course is equally available to petitioner and to the Appellate Court. Petitioner submits that the trial court is in error in this regard and suggests that many commercial loans are made to borrowers to enable them to start business. In a free enterprise system, it is a strange philosophy indeed to suggest that only he who has sufficient money of his own to do so may embark upon a new business enterprise.

However, even if the making of such a loan to assist a lender to start business is itself unusual in ordinary commercial transactions, such unusualness does not justify the further inference, in the light of the circumstances existing here, that the testifying stockholders were lying or that the notes were not genuine. The court's essential error in this regard lies in the fact that he is testing the veracity of the incorporators expressed intent by standards which have no bearing upon the situation present here. Conscious though it be, for another purpose, of the individual creditors' status as stockholders, the court is apparently completely unmindful of that status for the purpose of determining whether or not they are

telling the truth when they say they intended to make loans. Instead, the court seems to ask itself: Would a bank lend something less than approximately one-half of the funds needed by this petitioner to commence business? It then answers that question in the negative and infers therefore that no lender of money would do so, regardless of the interest which another lender of money might have in the ultimate business success of the enterprise. If under such circumstances, an inference of sham may be drawn from the fact that a bank would not make an unsecured loan for the purpose present here, such an inference should have been compulsory in the *Toledo Blade* case, *supra*, 11 T. C. 128 (1948), where the loans represented six-sevenths of the amounts originally needed by the debtor there to start business and where the court itself admitted there was no apparent business purpose for a loan. Such an inference should have been compulsory in the *Cleveland Adolph Mayer* case, *supra*, 6 T. C. 730 (1946), where the proceeds of the loan represented almost 100% of the funds needed and used by the taxpayer there to start business. Such an inference should have been compulsory in the *Clyde Bacon, Inc.* case, *supra*, 4 T. C. 1107 (1945), where nine-tenths of the funds needed by the corporate taxpayer there to start business was advanced to it, without security, by its stockholders. It is patent that in those three cases the Tax Court recognized that persons who have a proprietary interest in a corporation are likely to be more willing than banks to make unsecured loans to the corporation to assist it to start business and that because such proprietary lenders are likely to be more lenient, no inference can be drawn from the mere fact that their actions may differ from a cautious bank's lending policy.

As to the second attribute troubling the court, that,

“The amount of \$55,000.00 was required to place the restaurant in the condition to commence business, yet there was no agreement to advance the final \$30,000.00 paid in until November 12, 1941, a week after the restaurant opened for business.” [Op., R. p. 37.]

it should be noted that by November 12, 1941, all but the final \$20,000.00 rather than \$30,000.00 had been paid in [Stip., par. 6, R. pp. 257, 258]. Of said balance of \$20,000.00, McDonnell had definitely committed himself to pay \$5,000.00 to bring his advances to a par with the other two groups, in line with the original agreement.

It may be true that there was no formal commitment on the part of the three groups to contribute the final \$15,000.00 until November 12, 1941, but it is impossible to see why the lack thereof can support an inference that the testifying stockholders were lying when they testified that they intended to be loans to the petitioner, approximately one-half of the advances which they had made or to justify an inference that the notes were not genuine. As each advance prior to November was made, as the court expressly found, “the individuals intended that stock would be issued for one-half thereof, and notes for the remainder.” [F. of F., R. p. 30.] If then, the individuals intended notes to be given to them in the amount of one-half of these advances, how could the absence of a formal commitment to make additional advances affect the intent as to the advances made before November. As to the remaining advances made in November, those were agreed upon by the individual stockholders on November 12, 1941 [F. of F., R. p. 32] and formally by petitioner

on November 13, 1941. [F. of F., R. p. 32 and Pet. Ex. 12.] That agreement called for the execution and delivery of notes, as well as for the issuance of stock. [F. of F., R. p. 30.] In other words the court finds expressly that of the \$35,000.00 actually paid (and the additional \$5,000.00 inferentially committed by McDonnell) prior to November the individuals intended to receive from petitioner notes for one-half thereof, or \$20,000.00 and the court further finds that as to the \$15,000.00 advanced in November there was an agreement upon a division between stock and notes. Yet the court seems to infer that in spite of this intent, which it finds to be present on each occasion that advances were made prior to November, there was no such intent at the time of such advance because there was no commitment to do anything further beyond the advance. Petitioner submits that a trial court may not make an express finding of fact based upon evidence that could call for no other finding and then, in its opinion, infer the falsity of that fact simply to justify its ultimate conclusion.

As to the third attribute, that,

“Until then November 12, 1941 no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans.” [Op., R. p. 37.]

it is difficult to understand why the court should be troubled with a lack of what it calls “a final” agreement and why because of that lack until November 12, 1941, it should infer that the notes issued pursuant to agreement could not have been genuine. This it is submitted is a complete *non sequitur*. Here again, for this purpose, the court seems to forget the interests of the lenders in peti-

tioner's business enterprise and rather sets up as a standard to test their veracity the requirements of a commercial bank. Moreover in drawing its inference that no loans were intended it seems to forget too that it expressly found as a fact that as to monies paid in prior to November 12, 1941, the parties intended to invest one-half in petitioner's stock and to lend one-half. What happened thereafter is readily understandable. On November 12th there was a further agreement that additional amounts would be paid into the company, making an overall total of \$55,000.00, and it was further agreed that a total of \$25,000.00 of this amount would be paid into the company as a loan. Pursuant to the original understanding and that arrived at on November 12th, such moneys were paid in and notes were issued in the total sum of \$25,000.00. If any inference is to be drawn from these facts, petitioner submits that the inference must be that the notes were genuine since the execution and delivery of the notes were consistent with that agreement.

If the court is troubled by the fact that instead of conforming exactly to the original idea that full one-half of the moneys paid to the company was intended to be paid as loans, a somewhat lesser amount of notes were issued, that too is easily explainable. The only variation between the plan as originally adopted and as finally carried out was the agreement by the individuals to waive a small portion of their loans and to accept stock in lieu thereof. Whether this be deemed a variation or considered a positive payment of the loan by the issuance of stock is immaterial. The fact is that had they so chosen, the stockholders could have contributed to capital amounts in excess of that which they had committed to pay to the cor-

poration. However, while the corporation was free to receive, it was not free to give away, and under California law, could not agree to treat as a loan moneys which had been paid to it pursuant to a commitment to purchase stock. (Sec. 824 Corp. Code of the State of California.) It follows then that the parties were not, as the trial court suggested, "at all times in a position to divide the advances between stock and notes in any proportion." Their freedom was limited only to the increase of the stock purchased, if they so chose, or to the contribution to capital. They could not lawfully decide to increase the proportion of the loans and they did not do so.

Except as to this permissible variation, however, the conduct of the individuals was entirely consistent with the original plan. By July of 1941, they were already aware of the probability that the original estimate was too low and that the corporation would have to procure additional funds, but during the entire period, from April through November of 1942, the individuals continued to understand that approximately one-half of the advances which they were making were to be repaid as loans. They so stated to each other [R. pp. 23-24], to their attorneys [Dep., R. p. 251] and to the California Corporation Commissioner. [Ex. 4-D, R. p. 301.] That on November 12, 1941, they decided to let the corporation have a trifle more of invested capital than they had previously committed themselves to give to it cannot of itself require that they do the same with the balance of their loans. Nor should that fact have weight to persuade a court to conclude that the original April agreement and the intent of the individuals as each cash advance was made, the existence and terms of which the court found to be true in its formal findings of fact, did not actually exist.

As to the fourth attribute, that,

“ . . . no interest . . . was incurred by petitioner prior to November 13, 1941. In the meantime there was no agreement on when interest would start, the rate of interest or an agreement with petitioner on when the loans would mature. . . .” [Op., R. p. 38.]

it should be remembered that the court is referring to the advances made prior to November 13, 1941. These are the very advances which the court in its express findings of fact found to be made by the advancers with the intention “that stock would be issued for one-half thereof and notes for the remainder.” [F. of F., R. p. 30.] This is another instance where the court in its opinion seeks to discard the fact actually found by it. The result is that because the parties made no express or written stipulation for the payment of interest and for a maturity date at the time they made the various advances which the court held to be genuine loans, the court infers that when they did make such stipulation for payment of interest and a maturity date by requiring and receiving promissory notes, the promissory notes were not genuine. This of course is an absurd result. The fact is that here again, for the purpose of judging the veracity of the testifying lenders, the court has completely disregarded their interest in the success of the business, a fact which for other purposes it has weighed so heavily against them.

5. The Asserted Expectation of the Parties With Respect to Payment at Maturity. [Op., R. p. 39.]

In its opinion [R. p. 39] the court states that the parties did not intend to assert the rights of a lender because they did not in all events expect repayment at maturity.

This statement is based upon the testimony of Simon (whose position the court properly assumes to be that of his brother) and of Carpenter. As the court points out, Simon “testified that he expected the note to be paid at maturity but would not have insisted upon payment if payment would result in financial hardship to petitioner.” [Op., R. p. 39.] Carpenter testified that “he did not expect payment unless petitioner had funds.” [Op., R. p. 39.] To judge whether the court is justified in jumping from Simon’s possible leniency in an extreme situation to the conclusion that he did not intend to assert rights of a *bona fide* lender, reference is made to the testimony given on Simon’s cross-examination, to which the opinion refers, as follows:

“Q. . . . Was it your intention at the time this note was executed to demand payment of that note at its due date, regardless of the financial condition of the corporation at the time?

A. That is right.

Q. It was?

A. Yes, sir.

Q. Even though it meant the liquidation of the business?

A. I don’t suppose so. I would be very fair about it.

Q. In other words you would not have insisted upon the payment of this note at its due date if it meant a financial hardship to the business?

A. No, I don’t suppose I would.” [Tr., R. p. 90.]

It is clear from the foregoing, as well as from all of Simon’s other testimony, that Simon was not discussing his right as a creditor but was merely speculating, at respondent’s counsel’s invitation, as to what he might do to

avoid bankruptcy if, at the time his loan matured, the corporation found itself hard pressed for funds. To convert the witness' speculation as to his probable leniency, if that seemed a wise thing to do, into an absence of the intent to make a loan is to ignore the actualities of business life. This is something that any creditor, in an appropriate situation, might do. To suggest that because any creditor, let alone one who also had a proprietary interest in the business, does not intend to assert his rights as a creditor because he may not, in case of default, in all events force the borrower into bankruptcy or liquidation is to say that very few of the loans made in business, even by banks are *bona fide* loans. As to Carpenter's speculation, it was, as the court points out, that he did not *expect* payment unless petitioner had funds. That, it is submitted, is true of any creditor's expectation as to payment and is clearly not of such significance as to cause the court to forget it had found that Carpenter had intended to make a loan and consequently had *intended* to be repaid.

6. The Treatment of the Notes on the Books. [Op., R. pp. 38-39.]

The bookkeeping entries are significant only insofar as they bear upon the factual issue of the intention of the parties making the advances. The petitioner readily admits that bookkeeping entries made with the knowledge of a principal or pursuant to his orders may validly be used as the basis for an inference as to the principal's intention with respect to the matter recorded. The fallacy in attempting to draw such an inference as to intention, where the person for whose intention we are seeking, had no actual knowledge of the entries made is readily apparent. Inferences as to intention may only be drawn from the

words and acts of the party whose intention is to be determined.

An examination of the uncontradicted testimony of the witnesses, Whittaker, Aye, Tompkins and Carpenter, makes clear that the bookkeeping entries in question in the case at bar were made wholly without the knowledge, authority or direction of any of the parties whose intention is in issue. Rather, the entries to which the trial court refers were a result of an error on the part of the accountant, Whittaker and the petitioner's bookkeeper.

Benjamin Whittaker, called as a witness by the respondent, testified that Carpenter came to his office in 1941 to request that Whittaker outline a set of records for Carpenter's bookkeeper to install and use. [Tr., R. p. 100.] In October of 1941, he received the minute book of the petitioner from Mr. Odell for use in preparing the outline of the books and the opening journal entry. [Tr., R. pp. 101-102.] He did not scrutinize the minutes closely but looked through them for anything that might affect the corporation's books. [Tr., R. p. 102.] At no time did he discuss with Carpenter the manner in which the advances by the stockholders were to be handled on the books. [Tr., R. p. 104.] After returning the minute book to Mr. Odell on October 23, 1941, he never saw any minutes which were later included in the minute book. [Tr., R. p. 105.]

It is important to note in this connection that the minutes as of the time they were examined by Whittaker in October of 1941 did not contain any information as to the ultimate agreement with respect to the amount of the advances theretofore made to be considered as investment in stock and as loans. That agreement was reached at a stockholders' meeting held on November 13, 1941. [Tr., R.

pp. 67-69; Pet. Ex. 12.] There was, therefore, a complete lack of any instructions as regards the handling of the notes on the books.

Carpenter testified that he knew nothing about the books of account [Tr., R. pp. 143, 156] or that they did not up to April, 1942, show any notes payable to stockholders. [Tr., R. p. 157.] The first time he became aware of such omission was December 3, 1947, the first day of the trial in this proceeding. [Tr., R. p. 158.] He did not realize that it was necessary that the notes be recorded on the books and had no knowledge of books or bookkeeping. As president of the corporation his interest in the books was limited to examinations to determine the cost of items purchased by the corporation. [Tr., R. p. 169.] His complete confidence in and reliance upon his accountant in the management of the accounting aspects of the business is evidenced by the fact that he signed the petitioner's 1941 income tax return without examining it. [Tr., R. pp. 110, 144.]

Elias J. Aye testified that in April or May of 1942, he was asked by William Simon and Mike Lyman, his clients, to look at the petitioner's books and inform them as to their contents. [Tr., R. p. 193.] Having been acquainted with Mr. Simon's business, he knew that Simon had taken notes from the petitioner. [Tr., R. p. 184.] His trial balance taken in April or May, 1942, disclosed that no notes were shown on the books. [Tr., R. p. 184.] He so reported to Simon and Carpenter and they agreed that the entries were wrong and directed him to make whatever correcting entries were necessary. [Tr., R. p. 184.] He then set up the notes and the capital stock, the way the stock had been issued in accordance with the permit from the Corporation Commissioner [Tr., R. pp.

185, 186], \$30,000.00 capital stock and \$25,000.00 notes payable. [Tr., R. p. 192.]

The impossibility of drawing an inference as to the intention of the parties from such a state of facts has already been demonstrated. The trial court itself found that the books "*erroneously* reflected the capital stock outstanding." (Italics ours.) Its treatment of this factor is another example of its failure to keep the issue before it clearly in mind at all times. With the issue clearly defined it could not but have realized the immateriality of the bookkeeping entries unless they were made with the knowledge of the parties whose intention is in issue.

The evidence relating to the recording of interest accruals on the books likewise demonstrates only the inexperienced manner in which the books were kept. The testimony of Carpenter as to his complete lack of supervision and understanding of the books is equally applicable here to attest to the fact that the absence of these entries was also unknown to him. The proper entries were made by Mr. Tompkins only upon the direction of Mr. Aye after he had discovered the omission in preparing the corporation's income tax return for 1942. [Tr., R. p. 213.] The record at no point justifies charging the note holders with knowledge of the omission. Again the true state of the facts shows that this factor is in no way relevant to the issue of the intention of the parties making the advances. Upon the record as it stands, the treatment of the notes on the books has no significance in determining the intention of the parties.

IV.

Should This Court Be of the Opinion That the Tax Court Drew the Ultimate Inference Which Supports Its Decision It Nevertheless Remains Free to Draw Those Ultimate Inferences and Conclusions Which in Its Opinion the Findings of the Tax Court Reasonably Induce.

The scope of review of the decisions of the Tax Court of the United States by the Court of Appeals is no longer subject to the restriction imposed by *Dobson v. Commissioner of Internal Revenue*, 320 U. S. 489, 88 L. Ed. 248 (1943), since the amendment to I. R. C. Section 1141(a) which became effective September 1, 1948. The Courts of Appeal now having jurisdiction to review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Court in civil actions tried without a jury."

It has long been established that Circuit Courts will not set aside or disturb findings of fact of the District Court unless they are "clearly wrong," "unsupported by the evidence" or "unsupported by substantial evidence." (Rule 52(a) Federal Rules of Civil Procedure, 28 U. S. C. A. following Section 273(c), *Mente & Co. v. Isthmian S. S. Co.*, 122 F. (2d) 266 (C. C. A. 2d 1941); *Pressed Metals of America, Inc. v. Woodworth*, 119 F. (2d) 210 (C. C. A. 6th 1941).) But this rule has been restricted to situations in which the subjects of review are evidentiary or primary facts which the trial court has found upon hearing witnesses who appeared before it so that it was in a better position than the reviewing court to judge their

credibility as opposed to situations in which the question is one of drawing inferences from facts as found by the trial court. In the latter situation, the reviewing court is in as good a position to draw its own inferences or conclusions from the evidentiary facts as found by the trial court as is the trial court itself, since there is no question of credibility of witnesses involved.

The leading case setting forth the principle above stated is *Kuhn v. Princess Lida of Thurn & Taxis*, 119 F. (2d) 704 (C. C. A. 3d 1941). In that case, the plaintiff sued for reasonable attorneys' fees for professional services rendered to the defendant in connection with the review by the Board of Tax Appeals of a proposed deficiency assessment. The District Court found that \$8500.00 was reasonable attorneys' fees considering all the facts of the case, including difficulty of legal problems involved, amount of time necessarily spent in litigation and other matters. The Circuit Court reversed and remanded with direction to enter judgment for \$2500.00 in favor of the plaintiff. The court said that the conclusion as to the reasonable value of the services was an ultimate fact and so subject to complete review on appeal. As the court so aptly put it at pages 705-706:

“the Rule does not operate, however, to entrench with like finality inferences or conclusions drawn by the trial court from its fact findings and so, while accepting the facts, competently found by the trial court as correct, an Appellate Court remains free to draw the ultimate inferences and conclusions which, in its opinion, the findings reasonably induce.”

To the same effect is *Murray v. Noblesville Milling Co.*, 131 F. 2d 470 (C. C. A. 7th 1942), cert. den. 318 U. S. 775, 87 L. Ed. 1145 (1943), where there was a suit by

some 25 employees of the defendants for unpaid compensation under the Fair Labor Standards Act, Section 7(a). The issue was whether the plaintiff's employees had agreed to abrogation of the existing contract and had agreed to work for new rates rather than the rates established by the previous contract. The District Court having found all of the evidentiary or primary facts, found that the new contracts were not *bona fide* contracts of employment and were not intended to fix rates at which the employees were employed. The Circuit Court, citing the *Kuhn* case, *supra*, held that the contracts were *bona fide* contracts of employment and were intended to, and did fix the regular rate at which the employees were to be employed, and reversed the District Court to that extent. They stated that the question of the intention with which the parties entered into the contract was an ultimate fact and consequently, on the basis of the *Kuhn* case, *supra*, subject to complete review by the reviewing court. For further authority in support of this principle see *Adams County v. Northern Pacific Railway Co.*, 115 F. (2d) 768 (C. C. A. 9th 1940), where this court applied the same rule to findings of a special master and *Stubbs v. Fulton National Bank of Atlanta*, 146 F. (2d) 558 (C. C. A. 5th 1945), cert. den. 325 U. S. 864, 89 L. Ed. 1984 (1946).

As applied to the case at bar, the ultimate inference is, as we have set forth above, the inference as to the intention with which the parties made the advances to the petitioner. Inferences must be drawn from the relevant facts found by the Tax Court hereinbefore discussed which inferences this court is as competent to draw as the Tax Court. As we have said before, it is difficult if not impossible, to determine the basis for the Tax Court's decision in this case. Our interpretation of the decision is such that the Tax Court has found in our favor on this

issue. Should however, this court decide that the Tax Court did draw the inference which supports its decision, this court, sitting as a court of review, remains free to determine the intention of the parties from the primary facts competently found by the trial court without regard to whether or not there is support in the record for the inference drawn by the Tax Court. That, however, only one reasonable inference can be drawn in the premises, that is that the parties intended to make loans, is manifest from an examination of the evidence and the facts competently found by the Tax Court.

That such was the intention of Congress in enacting the amendment to I. R. C. Section 1141(a) is apparent from the committee report relating to this amendment. There the Senate Committee on the Judiciary stated that the language used in the house bill and adopted by the Senate had the effect of repealing the rule laid down in *Dobson v. Commissioner of Internal Revenue*, *supra*, "to the effect that decisions of the Tax Court on questions of fact, including questions of accounting and ultimate conclusions of fact, are not reviewable if supported by any evidence in the record." (Sen. Comm. on Jud., 80th Cong., 2d Sess. Report No. 1559, p. 131.) There we see the Senate Judiciary Committee drawing the distinction laid down in the *Kuhn* case, *supra*, as to questions of primary fact and ultimate conclusions of fact. Their very reference to that distinction makes it clear that it was the Congressional intent in enacting Section 1141(a) of the Internal Revenue Code to do away with the many times unfair result reached by applying the mandate of the *Dobson* case, *supra*, particularly as such mandate related to review of ultimate conclusions of fact and inferences drawn from findings of evidentiary fact. It was the intention of Congress that Courts of Appeals sitting in review of de-

cisions of the Tax Court of the United States should be free to reverse decisions of the Tax Court on questions of ultimate fact and inference drawn from primary facts without reference to whether or not the conclusion of the Tax Court had support in the record. It was the Congressional intention that by insuring that the most reasonable of two conflicting inferences would be chosen justice would be done to all litigants who choose to have their tax liability determined by the courts.

Conclusion.

Only one reasonable conclusion can be reached from the facts which exist in the case at bar—that a valid indebtedness of the petitioner existed, and therefore the interest which was accrued thereon in the taxable years here in question is deductible by the petitioner in computing its net income subject to the tax.

The decision of the Tax Court should, therefore, be reversed and judgment entered in favor of the petitioner allowing as a deduction the interest accrued in the taxable years 1942 and 1943.

Respectfully submitted,

SWARTS, TANNENBAUM, ZIFFREN & STEINBERG AND
JACOB SHEARER,

Attorneys for Petitioner.

DAVID TANNENBAUM,
JACOB SHEARER,
MITCHELL AARONSON,

Of Counsel,







APPENDIX.

INTERNAL REVENUE CODE SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

. . . (b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

INTERNAL REVENUE CODE SEC. 1141. COURTS OF REVIEW.

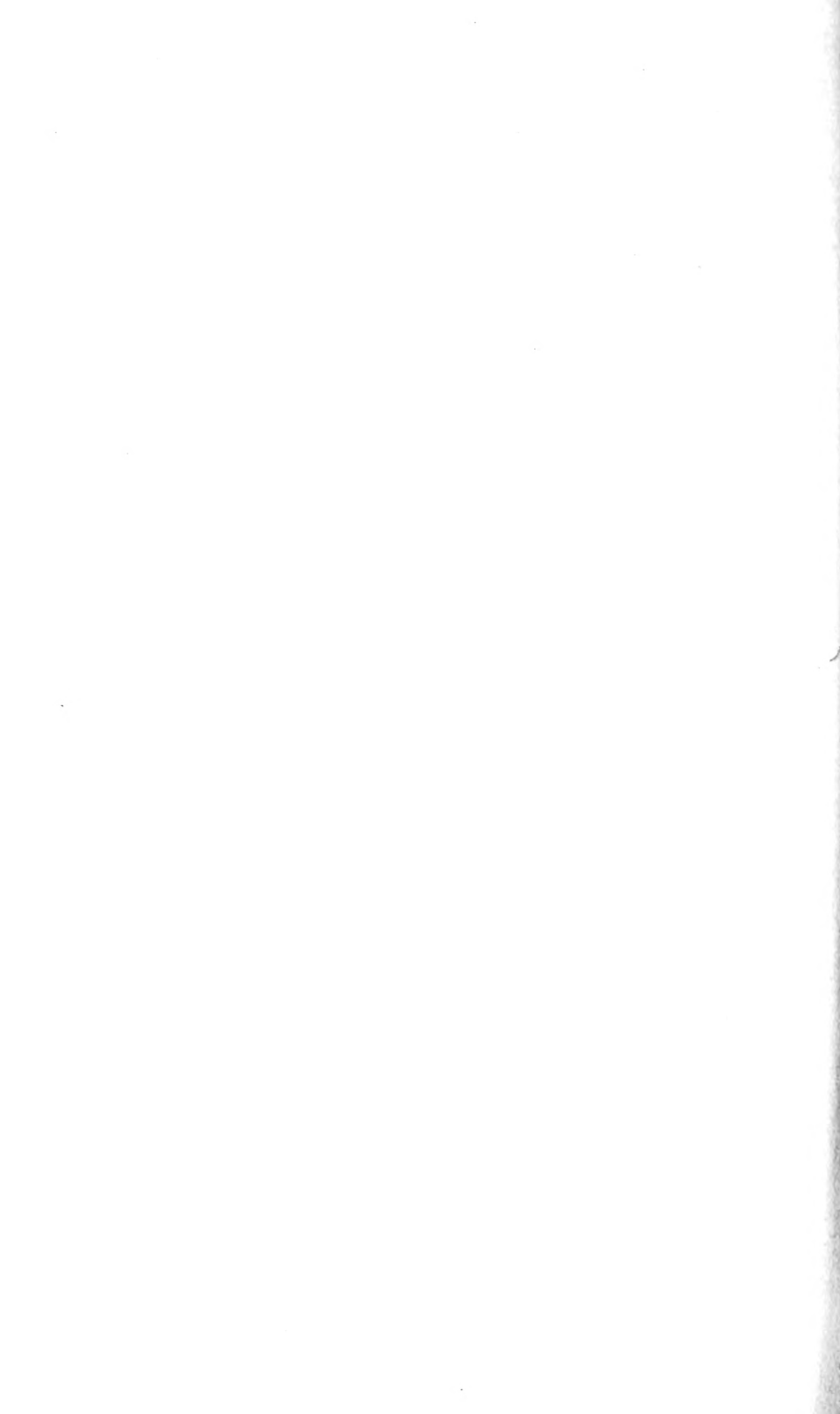
(a) JURISDICTION.—The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code.

CALIFORNIA CORPORATIONS CODE SEC. 824. UNLAWFUL PURCHASE OF SHARES, DECLARATION OR PAYMENT OF DIVIDENDS, OR WITHDRAWAL OR DISTRIBUTION OF ASSETS. Except as provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

EXCERPT FROM "JANEWAY V. COMMISSIONER," 2 T. C. 197 (1943) at page 202:

"Our examination of this interesting question convinces us that the petitioners held securities under section 23(g) (2) and (3). The substance, and not the form of what was done, controls for the tax purpose here involved. Although the parties did set this matter up on the corporate records as one of issuing notes plus stock, and although the petitioners contend that the stock was a mere bonus in consideration of the loan of money to the corporation, in our view one salient fact requires a negative answer to such contention: All of the corporate stock issued in connection with the advancements of money was issued in direct proportion to the amount of money put out by the stockholders; that is to say, that for each \$1,000 advanced by the two petitioners, by White and by Thomas, the other stockholders, each received six-tenths of a share of stock. The fact that for the last \$1,000 advanced by each no stock was issued was, under the evidence, mere inadvertence. It was issued, as was all the other stock, under the resolution of March 8, 1934, providing for the issuance of the six-tenths share of stock for each \$1,000. Considering the fact of such issuance in precise proportion to the amount of money advanced by the stockholders, we can not hold the stock, although issued in small quantities, to be a mere bonus, of no consequence to the present question; for the fact that the stock was issued in small quantities is immaterial, since the entire stock issue was only 22.8 shares.

“Not only are the petitioners not mere creditors, but also stockholders, but when they received the notes and stock they received pro rata control of the corporation through ownership of its stock in proportion to the amount of money advanced. Had the corporation earned large amounts of money, the petitioners would have been entitled to the whole thereof, that is, in accordance with their portion of the 22.8 shares of stock extant. In such a situation, we think we may not regard the stock as a mere bonus given because of the loan of money, as in substance the petitioners view the matter. The effect was that in return for the money and in exact proportion thereto, the petitioners and the other stockholders received a capital interest in and control of the corporation, and all of its assets, earnings, and profits. The effect would have been in nowise different had 1,000 shares issued for each \$1,000 contributed, for the stockholders, including the petitioners, controlled the corporation just as effectively with 22.8 shares of stock as they would have with several thousand shares, they having, though in small amount, the entire capital stock. Though, as petitioners argue, it was their intention to receive notes for the money put out by them, it was also their intention to receive, and they did receive with the other stockholders in like position as to advancements, the entire issued capital stock of the corporation and all the control and value it entailed, in proportion to the money which went into the corporation.”



No. 12079

**In the United States Court of Appeals
for the Ninth Circuit**

**WILSHIRE & WESTERN SANDWICHES, INC., A CORPORATION,
PETITIONER**

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES**

BRIEF FOR THE RESPONDENT

THERON LAMAR CAUDLE,

Assistant Attorney General.

ELLIS N. SLACK,

SUMNER M. REDSTONE,

Special Assistants to the Attorney General.

FILED

MAY 28 1949

PAUL P. O'BRIEN,

CLERK

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The Tax Court properly determined that advances made to tax- payer by its incorporators were contributions to taxpayer's capital and that purported "interest" payments were not de- ductible under Section 23 (b)	14
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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum opinion of the Tax Court (R. 27-40) is not reported.

JURISDICTION

The petition for review (R. 42-46) involves federal income taxes for the years 1942 and 1943 and declared value excess profits taxes for the year 1943. On January 31, 1946, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency in the total amount of \$3,347.95. (R. 8-9.) Within ninety days thereafter and on April 24, 1946, the taxpayer filed a petition for a redetermination of that deficiency with the Tax Court under the provisions of Section 272 of the Internal Revenue Code. (R. 4-22.) The decision

of the Tax Court sustaining the deficiency was entered on June 29, 1948. (R. 41.) The case is brought to this Court by a petition for review filed September 20, 1948 (R. 47), pursuant to Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Did the Tax Court correctly determine that advances made to the taxpayer by its incorporators did not create an "indebtedness" within the meaning of Section 23 (b) but were contributions to taxpayer's capital, and that purported "interest" payments were not deductible?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest*.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.23 (b)-1. *Interest*.—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *

* * * * *

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in

the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, section 121 and section 29.22 (a)-17.) * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

Sec. 35.719-1. *Borrowed Invested Capital*.—* * *

* * * * *

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

STATEMENT

The facts as found by the Tax Court are as follows (R. 27-35):

The taxpayer was incorporated on March 24, 1941, under the laws of California, with an authorized capital

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STATEMENT

The facts as found by the Tax Court are as follows (R. 27-35):

The taxpayer was incorporated on March 24, 1941, under the laws of California, with an authorized capital

stock of 7,500 shares of common stock, par value \$10 each, for the purpose of engaging in the drive-in restaurant business. The incorporators of taxpayer were M. A. McDonnell, William H. Simon, Mike Lyman, and Harry B. Carpenter. (R. 27.) Its articles of incorporation empowered taxpayer, among other things, to borrow money and issue its notes therefor. (R. 27-28.) It kept its books and prepared its returns on the accrual basis. It filed its returns for the taxable years with the Collector for the Sixth District of California. (R. 28.)

Discussions resulting in the formation of taxpayer started the early part of 1941. The original plan was to operate a combination drive-in and restaurant and cocktail room at Wilshire and Western Avenues, as a substitute for an old drive-in restaurant then being operated by Carpenter a block away. A lease was negotiated under the terms of which the lessor was to erect suitable improvements at a cost of about \$75,000. Carpenter did not desire to operate a combination restaurant on account of its size. In the meantime, Simon, acting for himself, negotiated a lease for another corner of Wilshire and Western Avenues for the purpose of operating a drive-in restaurant. Thereafter, but before taxpayer was incorporated, the interested parties abandoned the plan under consideration and decided to construct a drive-in restaurant on the lot covered by the lease negotiated by Simon. (R. 28.)

About April 1941, taxpayer's incorporators discussed for the first time the question of financing the construction of the restaurant out of advances by them to taxpayer for the purchase of its stock and as loans. The original intention was to make advances totaling \$30,000 for stock and loans on an equal basis. (R. 28.) The individuals desired to be in a position to participate with general creditors for part of their investment in the event taxpayer's business was not successful. (R. 28-29.) In addition, they regarded a loan to be a better

investment than stock to obtain returns on and repayment of their capital outlay. The individuals discussed the question of borrowing money from a bank and decided that they would rather receive the interest than to have taxpayer pay it to a bank. They also discussed the tax benefit that would accrue to them and taxpayer under the plan. Simon, who with his brother Mike Lyman was regarded as a unit in the transaction, considered his contemplated loan to be a safe investment. The same individuals, or some of them, entered into similar transactions for the same reasons with nine other corporations, one each in 1937 and 1939, six in 1941, and one in 1942. In all except two of the transactions, the notes received for loans were in proportion to the stock received. (R. 29.)

Simon negotiated for, and on April 26, 1941, entered into, a lease for a corner lot at Wilshire Boulevard and Western Avenue, Los Angeles, for a period of fifteen years. The lease provided for the improvement of the premises by a drive-in restaurant building at a cost of not less than \$30,000. The lease was acquired by Simon with the understanding that he would assign it to taxpayer, and was assigned by him to taxpayer in July, 1941. The understanding was that Carpenter would supervise the construction of the building and operate the business. (R. 29.) Three of the four individuals estimated that the improvements, including equipment, would cost about \$30,000. Carpenter, the other individual, first believed that the cost would be about \$50,000, and in July 1941, concluded that the cost would be \$38,000 or \$39,000. (R. 29-30.) Simon and Carpenter estimated that the cost of the equipment would about equal the cost of the building. (R. 30.)

About June 15, 1941, bids were solicited for the construction of the building on the leased premises, and on July 10, 1941, a contract was entered into for the construction of a building at a cost of \$22,651. The con-

struction work was substantially completed about October 25, 1941, and the restaurant was opened for business about November 5, 1941. (R. 30.)

The incorporators of taxpayer made the following payments, totaling \$55,000, to taxpayer in 1941 under the plan previously adopted by them (R. 30) :

	McDonnell	Simon	Lyman	Carpenter
May	\$3,333.33	\$	\$	\$
June	. . . . .	1,666.67	1,666.66	3,333.34
August	. . . . .	2,500.00	2,500.00	. . . . .
September	5,000.00	. . . . .	. . . . .	5,000.00
October	. . . . .	2,500.00	2,500.00	. . . . .
Nov. 13	. . . . .	2,500.00	2,500.00	. . . . .
Nov. 19	10,000.00	. . . . .	. . . . .	5,000.00

The payments made on November 13th and 19th were agreed upon at an informal meeting held on November 12. At the same meeting the parties reached an agreement on the division of the advances between stock and notes. At the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof, and notes for the remainder. No receipts were given by taxpayer for the advances. (R. 30.)

The money was first used to pay for the cost of preparing plans and specifications for the building, and thereafter for the construction of the building and the equipment installed therein. (R. 30-31.) The amount of \$38,114.68 was spent in 1941 for the building and \$17,515.78 for equipment, a total of \$55,630.46. In January 1942, the additional amount of \$2,375 was spent for building costs and, in that and the next month the additional amount of \$7,787.26 was spent for equipment. An expenditure of \$55,000 was necessary to place the restaurant in condition to open for business. (R. 31.)

About February 1, 1942, taxpayer borrowed \$10,000 from its stockholders to pay bills outstanding for the construction of the building and equipment of the

restaurant. Carpenter and McDonnell each loaned one-third of the amount and Simon and Lyman each a one-sixth. Carpenter did not advise the other stockholders of the need for the money until a short time before the loans were made. The loans were paid on September 7, 1942, without interest. (R. 31.)

About July 14, 1941, taxpayer, pursuant to a resolution adopted by its board of directors on that day, filed an application with the Department of Investment of the State of California for permission to issue 1,500 shares of its stock for cash to its incorporators, and G. C. Jobson, and the remainder of its stock when authorized by its board of directors. (R. 31.) The application recited that taxpayer proposed to borrow from the stockholders or incorporators an additional amount sufficient to complete the building and equip it for the operation of a restaurant. (R. 31-32.) At the same meeting, Carpenter was elected president and Simon vice president of taxpayer. On July 17, 1941, the Commissioner of Corporations authorized taxpayer to sell to the individuals named in its application for cash, at par, not to exceed 7,500 shares of its stock. (R. 32.)

At a meeting of the board of directors of taxpayer, the membership of which included the four incorporators, on November 13, 1941, a resolution was adopted, in accordance with an agreement reached at an informal meeting the previous day, to issue to the incorporators for advances made by them promissory notes, totaling \$25,000, maturing in two years with interest at the rate of 6 percent per annum, payable quarterly, and stock, totaling \$30,000, as follows (R. 32):

	Carpenter	McDonnell	Simon	Lyman
Stock	\$10,000.00	\$10,000.00	\$5,000.00	\$5,000.00
Notes	8,333.34	8,333.33	4,166.67	4,166.66

The stock and notes authorized by the resolution were issued under date of November 13, 1941, and were de-

livered by December 5, 1941. In case of default in the payment of interest, the notes were to be immediately due and payable at the option of the holder. On November 25, 1941, 50 shares each of the stock issued to Simon and Lyman were transferred to Joseph Lardemar, in accordance with a gift made of the stock prior to November 13, 1941. (R. 32.)

Carpenter expected the notes to be paid if taxpayer had funds for that purpose. (R. 32.) Simon expected the notes to be paid out of current earnings and would not have insisted upon payment if payment would have caused financial hardship to taxpayer. (R. 32-33.)

Amounts, totaling \$3,055.86, were paid to the note-holders on December 1943, as interest on the notes to November 30, 1943. Like payments, aggregating \$682.10, were paid on March 23, 1945. The amounts were entered on the books of taxpayer as a charge to an account under the name of "Interest Payable Accrued," which account was opened in February or March 1943, as of the close of 1942, with a credit to the account as interest accrued on the notes to December 31, 1942. The face amount of the notes was paid in full by payments of \$10,000 each, on April 21, 1943, and May 23, 1944, and \$5,000 on March 23, 1945. The payment to the holder of each note was in proportion to his holdings of all of the notes. (R. 33.)

In October, 1941, Carpenter requested a certified public accountant to outline a set of books for taxpayer's bookkeeper to install and use. After receiving the minutes of taxpayer, the accountant prepared a list of entries. The journal entry showed that taxpayer was incorporated with a capital of \$75,000, consisting of 7,500 shares of a par value of \$10 each. The outline of accounts to be used included an account for notes payable. Carpenter did not inform the accountant that part of the advances made by the incorporators was to be treated as loans to the corporation. (R. 33.)

Taxpayer's account under the name of "Capital Stock Unissued" contained a charge of \$75,000 and a credit of \$55,000 on December 31, 1941. Its account "Stock Subscriptions Receivable" contained at that time a charge of \$55,000 and a credit for the same amount. (R. 33-34.) The books also showed capital stock of \$75,000, of which \$55,000 was set aside against an account under the name of "Cash Special \$55,000." The books did not, on December 31, 1941, reflect any notes payable to stockholders. Sometime between January 15 and March 7, in 1942, the accountant took a trial balance from taxpayer's books for the purpose of preparing taxpayer's income tax returns for 1941. The balance sheet included in the income and declared value excess profits tax return listed as an asset capital stock subscriptions in the amount of \$55,000 and as a liability a like amount for capital stock. The return was signed by Carpenter, as president, and H. B. Carpenter, Jr., as treasurer, without objection to the return as prepared by the accountant or reading the return. Taxpayer's president was aware that the affidavit he signed contained a statement that the return was correct. (R. 34.)

In April or May, 1942, taxpayer employed another accountant to examine its books. The accountant had knowledge that the stockholders of taxpayer held notes of the corporation. He ascertained from a trial balance taken as of December 31, 1941, that the books did not reflect the notes issued to the stockholders under the date of November 13, 1941, and erroneously reflected the capital stock outstanding. (R. 34.) After discussing the matter with Carpenter and Simon, the accountant made entries in the books to reflect notes outstanding of \$25,000 and capital stock outstanding of \$30,000. (R. 34-35.) While the accountant was preparing taxpayer's income tax return for 1942, he ascertained that no amount had been accrued for interest on the notes. An appropriate account was then opened and the amount

of \$1,687.50 was entered therein as interest accrued on the notes to the close of 1942. Thereafter interest was accrued on the notes monthly. (R. 35.)

The earned surplus account of taxpayer discloses credit balances of \$2,468.16, \$9,740.40, \$17,980.01, \$45,752.61, \$51,349.06, and \$59,289.40 at the close of the years 1941 to 1946, inclusive. The account contains no charge for dividends. (R. 35.)

Taxpayer's president, who testified at the hearing, was at an undisclosed time indicted in a Federal District Court in California for filing false and fraudulent individual returns and like returns for a firm doing business under the name of Carpenter's Drive-In. At the trial, Carpenter entered a plea of *nolo contendere* and paid a fine, imposed by the court. No sentence of imprisonment was imposed by the court. (R. 35.)

In its returns for 1942 and 1943 the taxpayer claimed \$1,500 and \$1,443.26, respectively, as deductions for interest on the notes held by its stockholders. In his determination of the deficiencies the Commissioner held that the amounts were not deductible under Section 23 (b) of the Internal Revenue Code. (R. 35.)

The Tax Court found also in its opinion as follows:

The general plan was decided upon prior to any business activity of taxpayer and was intended to meet capital outlays which are usually paid out of invested capital and/or secured indebtedness. Similar arrangements were made by the stockholders, or some of them, in connection with other corporations formed to engage in the restaurant business. (R. 36.) No evidence was offered to establish that the individuals were lenders of money other than under plans such as the one here under consideration. (R. 36-37.)

The advances here have few of the usual characteristics of commercial loans entered into in arm's length transactions. All of the amounts were paid in to pro-

vide taxpayer with funds to start business, hence all of it was working capital. The original plan was to take stock and notes on an equal basis and three of the four interested parties estimated that an expenditure of about \$30,000 would be sufficient to open the restaurant for business. The amount of \$55,000 was required to place the restaurant in condition to commence business, yet there was no agreement to advance the final \$30,000 paid in until November 12, 1941, which was a week after the restaurant was opened for business, and until then no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans. The plan finally adopted and made effective on the division of the advances between stock and notes was not in accordance with the agreement originally entered into, which discloses that the parties were at all times in a position to divide the advances between stock and notes in any proportion. The portion regarded as a loan by each stockholder was in direct proportion to his holding of stock. (R. 37.)

Some of the funds were advanced as early as May 1941, yet no interest thereon was incurred by taxpayer prior to November 13, 1941. In the meantime, there was no agreement on when interest would start, the rate of interest, or an agreement with taxpayer on when the loans would mature, contrary to the manner loans are generally made. (R. 38.)

The notes were not entered in the books until April or May 1942, and although interest was payable quarterly, none was accrued on the books until 1943 and no interest was paid until December 1, 1943, or more than two years after the notes were executed. The terms of the instruments gave to the holders thereof the right to declare the principal and interest immediately due and payable upon default in the payment of interest when due. No evidence was offered that any of the note holders exer-

cised the right. The final payment on the notes was not made until March 23, 1945, or more than sixteen months after maturity, and the payment made each time to each was in direct proportion to his holdings of all of the notes. No evidence was offered to show any demand for payment at maturity. (R. 38.)

The intent of the parties with respect to a part of the advances as bona fide loans, is reflected in testimony of Simon, who, with his brother, was regarded as a unit in the transaction, and Carpenter. The former testified that he expected the note to be paid at maturity, but would not have insisted upon payment if payment would result in financial hardship to taxpayer. The latter did not expect payment unless taxpayer had funds. It is apparent from the testimony that they did not intend to assert rights of a bona fide lender; instead regarded the amounts as being subject to the risks of the business and looked to repayment out of corporate earnings. (R. 39.)

The taxpayer had earned surplus of about \$51,000 by the close of 1945, or double the amount of its outstanding stock, yet paid no dividends on its stock during that period, which strongly indicates that the stockholders looked to the notes for income on their investments and a partial return of capital. (R. 39.)

SUMMARY OF ARGUMENT

The single issue presented is whether certain payments made by taxpayer to its incorporators constituted "interest" on "indebtedness" and were deductible under Section 23 (b) of the Internal Revenue Code. Prior to the legislative rejection of the *Dobson* rule, appellate review of such questions was foreclosed. Contrary to taxpayer's contention however, the statutory change in the scope of this Court's reviewing powers does not grant taxpayer a *de novo* consideration of the evidence and issues, for the function of weighing evidence, drawing inferences, and choosing between

conflicting inferences is that of the Tax Court. The essential problem is whether a bona fide creditor relationship existed or, stated differently, whether the security holders actually intended to assert the rights of creditors. The precise boundaries of this Court's reviewing power are not significant in this case since the evidence overwhelmingly supports the determination of the Tax Court that a bona fide creditor relationship was not established but rather that the advances were contributions to taxpayer's capital. The incorporators, having received notes in direct proportion to their stock holdings in a closely held corporation, were in a position to convert a portion of their original capital investment to the form of indebtedness while retaining the same relative control and interest in the management, the assets and earnings of the taxpayer. Even after the advances were made to the taxpayer, the incorporators were in a position to formally divide their investment between notes and stock in such proportions as they desired. When the sums were advanced no maturity date was fixed, no interest rate was established and the amount of indebtedness was itself not fixed. The books of the taxpayer treated the entire advancement as capital. No "interest" was accrued on the books until almost two years after the purported "loans" and no "interest" was paid or apparently demanded until 1943, despite the fact that the notes issued in 1941 called for quarterly payments of "interest". The notes were not paid until sixteen months after the recited maturity date and the record does not show that any prior demand for payment was made. The interest and notes were paid out of earnings and constituted the only distributions of corporate earnings to the stockholders though ample funds were available. The testimony of the incorporators indicates that they did not intend to assert the rights of creditors unless the fortunes of the corporation so warranted.

The Tax Court Properly Determined That Advances Made to Taxpayer by Its Incorporators Were Contributions to Taxpayer's Capital and That Purported "Interest" Payments Were Not Deductible under Section 23 (b)

The single issue here presented is whether taxpayer has clearly established a right to deduct certain corporate payments as "interest" on "indebtedness" under Section 23 (b) of the Internal Revenue Code, *supra* (*White v. United States*, 305 U.S. 281, 292; *Deputy v. du Pont*, 308 U. S. 488, 493); or whether on the contrary the Tax Court was justified in holding that the alleged indebtedness was in reality a contribution to taxpayer's capital. The Commissioner is of course aware of the statutory change in this Court's scope of review of such questions and of the legislative rejection of the rule in *Dobson v. Commissioner*, 320 U. S. 489, discussed at some length by taxpayer. (Br. 43-47.) However the rejection of the *Dobson* rule which precluded appellate review of Tax Court determinations on such questions as that now presented (*John Kelley Co. v. Commissioner*, 326 U. S. 521), does not entitle the taxpayer to a *de novo* consideration of the case, which is the essence of taxpayer's contention. Long prior to the emergence of the *Dobson* rule it was firmly established that it was the province of the Tax Court "To draw inferences, to weigh the evidence and to declare the result * * *". *Helvering v. Nat. Grocery Co.*, 304 U. S. 282, 294; *Elmhurst Cemetery Co. v. Commissioner*, 300 U. S. 37, 40. Equally well established was the Tax Court's power to "choose between conflicting inferences". *Wilmington Co. v. Helvering*, 316 U. S. 164, 168. At any rate, such questions as to whether taxpayer's incorporators genuinely intended to occupy the status and assert the rights of creditors, and whether they intended that the purported "interest" payments be dependent upon the fortunes of the business are questions of pure fact; and

the Tax Court's determination in such respects may be disturbed only if clearly erroneous. Rule 52, Rules of Civil Procedure; Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess. Taxpayer's position is all the more extraordinary in view of the fact that taxpayer's affirmative case was almost entirely dependent upon the oral testimony of self-interested witnesses whose credibility was very much in issue and whose testimony, in the light of the actual course of events, was manifestly subject to conflicting inferences.

At the outset it is appropriate to consider the circumstances under which the original advances to the corporation were made. Where, as here, the total working capital of a closely held corporation is advanced by the incorporators who received not only stock but also "promissory notes" in direct proportion to their stock holdings, the transaction must be subjected to close scrutiny by the Commissioner and the courts. *Jane-way v. Commissioner*, 2 T. C. 197, affirmed, 147 F. 2d 602 (C. A. 2d). In each case the fundamental question is whether a creditor or a stockholder relationship exists; and where the incorporators receive both stock and "notes" in direct proportion to their respective investments, they are in a position to convert what is in essence a portion of their capital contribution to the form of indebtedness while retaining the same relative control and interest in the management and in the assets and earnings of the corporation. They are, in short, in a position to formally classify as interest payments sums of money to which they would be entitled as stockholders in the form of dividends. The Tax Court did not, as taxpayer suggests (Br. 21), lay down a rule of law that stockholders may not also be creditors of a corporation, nor did the Tax Court indicate that the fact that the notes and stocks were proportionate

to the relative investments was determinative. The Tax Court was however entitled to consider the circumstance in view of the oft repeated and fundamental principle that in the field of taxation the primary concern is with substance and reality and not with form. *Helvering v. Lazarus & Co.*, 308 U. S. 252; *United States v. Joliet & Chicago R. Co.*, 315 U. S. 44. In considering the circumstances surrounding the original investment it is interesting to note that not until after a substantial portion of the money invested was advanced to the corporation, was it determined how much should represent indebtedness and how much capital contribution. (R. 37.) Apparently it was originally agreed that the investment would be "split * * * up on a fifty-fifty basis, half in the form of loans, half in the form of capital contribution". (R. 28, 120.) Mr. Carpenter, taxpayer's president, testified that the incorporators "couldn't determine the amount to be issued in stock or the amount to be issued in notes" (R. 125); and, as the Tax Court found (R. 37), the plan finally adopted as to the division between stocks and notes was not in accordance with the original plan. The taxpayer in its brief (p. 35) explains the variance as being the consequence of an "agreement by the individuals to waive a small portion of their loans and to accept stock in lieu thereof". As the Tax Court noted (R. 37), this would indicate that the incorporators were at all times in a position to divide the advances between the stock and notes in whatever proportions they deemed advisable; and this would hardly indicate the existence of a bona fide creditor relationship. On the contrary, it seems manifest that the ultimate division between stock and "notes" was formalistic and without substance. Moreover, it is apparent that the incorporators were committed among themselves to advance the necessary capital in one form or

another; and when this be considered in connection with the additional fact (R. 37) that the entire \$55,000 advanced was necessary to place the restaurant in condition to commence business, it is reasonable to conclude that the entire funds supplied by the incorporators were subject to the hazards of the business and part of its capital structure. See *Green Bay & W. R. Co. v. Commissioner*, 147 F. 2d 585, 587 (C. A. 7th). The fact that no receipts were given the incorporators, that no interest was ever paid or accrued even belatedly for the period between the time the funds were advanced in May 1941 and November 1941, and the fact that the maturity date, the rate of interest and indeed the amount of "indebtedness" itself were not fixed when the purported "loans" were made (R. 38), cast substantial doubt on the existence of a bona fide creditor relationship.

When the overwhelming evidence in support of the Tax Court's determination is considered, in addition to the aforementioned circumstances surrounding the original investment, it is manifest that inquiry into the precise limits of this Court's review is not material in this case. Apart from the testimony of the incorporators to the effect that they intended that part of their investment to be taken in the form of loans, and the fact that "promissory notes" were issued, there is little in the record to support the contention that a bona fide creditor relationship existed. That the nomenclature given a security is not conclusive has long been established. *Commissioner v. Schmoll Fils Associated*, 110 F. 2d 611, 613 (C.A. 2d). It is significant that taxpayer's own books did not reflect any promissory notes or indebtedness to the taxpayer's incorporators. On the contrary the entire \$55,000 was originally listed as "Stock Subscriptions Receivable." The books showed a total capital stock of \$75,000 and no corporate indebt-

edness to the stockholders. Moreover some time prior to March 7, 1942, taxpayer's accountant took a trial balance from taxpayer's books for the purpose of preparing taxpayer's income tax return, and the balance sheets included in the income and declared value excess profits tax return listed as an asset capital stock in the amount of \$55,000. This return was signed by taxpayer's president. (R. 34, 102-104; Joint Ex. 8H.) Sometime subsequently a line was drawn through the 55 on taxpayer's books and this was changed to 30. A corresponding "note account" was then set up. (R. 160, 210.) No satisfactory explanation was offered as to the listing of the entire \$55,000 as a capital stock subscription. The initials of taxpayer's bookkeeper were entered in the books. (R. 178.) No error on the part of the bookkeeper or the accountant, Mr. Whittaker, was proved. If an error existed it seems clear that it was in the form and not in the substance of the corporate structure.

Still more important is the fact that although the "promissory notes" issued in 1941 provided for quarterly payments of "interest", no interest was even accrued on taxpayer's books until February or March 1943, and the first entry was dated back to December 31, 1942. (R. 214.) Moreover no "interest" was in fact paid until November or December 1943, nor is there any evidence that prior demand for an "interest" payment was ever made. (R. 38, 215.) When taxpayer's president was asked why no prior "interest" payments were made he replied "carelessness". (R. 141.) It is submitted that although such a reason might possibly have satisfied the corporation's stockholders, it would not have been satisfactory to a bona fide creditor. One of the fundamental characteristics of a creditor is the right to receive interest regardless of the fortunes of the business. *Commissioner v. Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C.A. 7th).

Another of the essential attributes of a creditor's obligation is a fixed date for the payment of the obligation. *Haffenreffer Brewing Co. v. Commissioner*, 116 F. 2d 465 (C.A. 1st), certiorari denied, 313 U. S. 567; *Commissioner v. O. P. P. Holding Corp.*, 76 F. 2d 11 (C.A. 2d). On the other hand the mere recitation of a maturity date in a security, especially where issued by a closely held corporation to its stockholders does not establish the fact that the parties actually intended payment of "a definite sum at a fixed time". *Commissioner v. O. P. P. Holding Corp.*, *supra*, p. 12. In the instant case the final payment of the notes was not made until May 23, 1945, or more than sixteen months after the maturity date recited in the notes. (R. 38, 139.) There is no evidence in the record to indicate that timely payment of the principal was ever demanded or that the holders of the "notes" had ever exercised the right given of declaring the principal and interest immediately due and payable upon default of the interest. (R. 38.) Again it is submitted that if the relationship was actually one of creditor and debtor, the creditors would not have been so lax in enforcing their rights and protecting their investment. The only reasonable conclusion to be drawn from the conduct of the parties is that it was never intended to assert the right to demand from the corporation a fixed amount on a fixed date in payment of the obligation, but rather that it was intended to recover this portion of the capital investment when and if the fortunes of the business warranted. It is interesting to note the observation of the Tax Court (R. 38-39) that an additional \$10,000 borrowed from the stockholders in 1942 was repaid the same year, or fifteen months prior to the first "interest" payment on the "notes" (R. 196). This variance in treatment would seem to highlight the distinction between the original advances evidenced by the "notes" and actually a part

of the necessary capital of the corporation, and the subsequent loan to the corporation by its stockholders to meet the temporary needs of the business. Moreover, as the lower court observed (R. 39), since no additional capital came into the business, the "notes" and the "interest" were in fact paid out of the revenue of the business. Since the taxpayer admittedly had an earned surplus of \$51,000 by the close of 1945, which was double the amount of its outstanding stock and yet paid no dividends on its stock during that period (R. 39), the Tax Court was justified in inferring that the stockholders looked to the notes for income on their investments and a partial return of capital.

As stated in *Commissioner v. Meridian & Thirteenth R. Co.*, *supra*, p. 186, "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event". The Tax Court concluded here that the incorporators did not intend to assert the rights of bona fide creditors, that the advances were intended to be subject to the risks of the business and that the incorporators expected to be repaid in full for the monies advanced in the form of loans only if the taxpayer had sufficient earnings to make the payments without financial hardship. (R. 39, 46.) The conclusions are supported not only by the previously discussed evidence but by the testimony of the incorporators. William Simon admitted on cross examination that he would not have insisted upon payment if it meant a financial hardship to the business. (R. 90.) Mr. Carpenter's testimony (R. 149-150) was at least subject to the inference that he expected the "notes" to be repaid only if taxpayer had funds available (R. 32). It is not surprising that the witnesses did not straightforwardly testify that they expected to be paid only out of earnings and

profits; for as a practical matter it must be recognized that the testimony was subject to the possibility of being colored by self-interest; and it was for the trial court to choose between the conflicting inferences. Taxpayer's suggestion (Br. 14) that the oral testimony of Simon was the only evidence before the Tax Court on the question of intent is not understandable in view of the overwhelming evidence previously discussed here and carefully considered by the Tax Court as bearing on the question of whether a creditor or a stockholder relationship existed in connection with the "notes". In seeking to explain the testimony of Simon to the effect that he did not intend to press his claim for the funds purportedly "loaned" if it meant financial hardship to the corporation, taxpayer suggests (Br. 39) that this is not extraordinary in view of Simon's proprietary interest. This position can hardly aid the taxpayer's case. It is the contention of the Commissioner that in advancing the sums involved to the corporation, the incorporators intended to act and did act as proprietors and not as creditors. Apparently it is taxpayer's position that the holders of the "notes" may treat themselves as creditors for taxation purposes but conduct themselves as stockholders in regard to the alleged "loans".

Nor is taxpayer's attack on the Tax Court's findings and conclusion at all justified. A reading of the formal findings of fact and the opinion suffices to demonstrate that the Tax Court gave careful consideration to all the evidence which bore on the real nature of the relationship between the incorporators and the taxpayer, and that the lower court thoroughly understood the applicable legal principles and correctly applied them. Taxpayer apparently assumes that there are a few fixed criteria beyond which the Tax Court may not look in determining whether the purported creditor relation-

ship was in substance a stockholder relationship. Moreover, taxpayer completely distorts the lower court's findings and opinion by segregating and independently considering each sentence of the findings and opinion out of context. The lack of merit in taxpayer's appeal becomes patent when the Court considers the fact that the stockholders received "notes" in direct proportion to their stockholdings; that they were apparently in a position to formally divide up their investment between stock and notes in whatever proportions they desired even after the sums were advanced; that when the sums were advanced no maturity date was fixed, no interest rate was established, and indeed the amount of indebtedness was not fixed; that the books of the corporation treated the entire advancement as capital; that no interest was accrued on the books until almost two years after the alleged "loans"; that no interest was paid or apparently demanded until 1943, despite the fact that the notes issued in 1941 called for quarterly payments; that the notes were not in fact paid until sixteen months after the recited maturity date, nor was any prior demand apparently made; that the interest and notes were in fact paid out of earnings and constituted the only distribution of corporate earnings to the stockholders though ample funds were available; and that the holders of the notes obviously did not intend to demand payment unless the fortunes of the corporation warranted.

Taxpayer's contention that the Tax Court's findings do not support its conclusion can be rationalized only by giving to the findings referred to a meaning obviously not intended by the lower court, and by considering the specific findings out of context. When the Tax Court, in reciting the facts, stated that it was originally intended to make advances for stock and loans on an equal basis, and that it was intended that stock be issued for half and notes be issued for the remainder, the Tax Court stated what is conceded by all, namely, that the

incorporators intended to take half their investment in the form of notes and half in the form of stock. These findings certainly did not signify that a bona fide creditor-debtor relationship was established or intended. Indeed the Tax Court specifically found to the contrary. (R. 39.)

CONCLUSION

The decision of the Tax Court is patently justified and indeed required by the facts and the law and should be sustained.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General

ELLIS N. SLACK,

SUMNER M. REDSTONE,

Special Assistants to the Attorney General

MARCH, 1949.



No. 12079

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILSHIRE & WESTERN SANDWICHES, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER.

Petition to Review a Decision of the Tax Court of the
United States

SWARTS, TANNENBAUM, ZIFFREN &
STEINBERG and JACOB SHEARER,
Attorneys for Petitioner.

DAVID TANNENBAUM,
JACOB SHEARER,
MITCHELL AARONSON,
650 South Spring Street,
Los Angeles 14, California,
Of Counsel.

FILED

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PAUL P. O'BRIEN,
CLERK



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In his brief, respondent twice (Resp. Br. p. 22) accuses counsel for petitioner of distorting the lower court's findings by considering findings out of context. Petitioner considers this a serious matter for it is tantamount to an accusation that counsel for petitioner are attempting to deceive this Court by misstating the record. For that reason petitioner adverts to the two specific instances given by respondent (Resp. Br. p. 22) of the so-called consideration of specific findings out of context.

One of the specific findings purportedly considered out of context was the finding that "the original intention was to make advances totalling Thirty Thousand Dollars (\$30,000.00) for stock and loans on an equal basis," which was treated in petitioner's brief at page 15. The other specific finding purportedly considered (Resp. Br. p.

16) out of context was the finding that “at the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof and notes for the remainder.” These findings were discussed by petitioner (Pet. Br. p. 15, *et seq.*) to support its contention that the Tax Court’s Conclusion of Law was not supported by its Findings of Fact.

An examination of the formal Findings of Fact with particular reference to the facts above quoted reveal that the Tax Court chose to make its formal Findings of Fact in narrative form. After reciting the historical background of the petitioner [R. p. 27] it proceeded chronologically to a point in April, 1941 [R. p. 28] the time of the first discussion by petitioner’s incorporators of “the question of financing the construction of the restaurant out of advances by them to Petitioner for the purchase of its stock and as loans.” [R. p. 28.] Immediately thereafter the Court recited the quoted finding concerning the original intention. Immediately following that finding the Court proceeded to elaborate upon what it felt to be the desires of the individual incorporators, by pointing out that these individuals wished to participate in part with general creditors if the business were not successful, that they regarded a loan to be a better investment than stock for the purpose of obtaining returns and repayment of capital, that they discussed the question of borrowing from the bank and decided that they preferred to receive the interest individually, that they discussed the tax benefits, that Simon and Lyman considered their “contemplated *loan* to be safe” that the same individuals had entered into similar transactions for the same reasons with respect to other corporations and with the exception of two occasions, “the *notes* received for *loans* were in proportion to the stock received.” (Italics ours.) [R. pp. 28-

29.] In the next paragraph the Court proceeds to talk about the negotiation by Simon for a lease for the premises, a subject which it is submitted, there is no reason to treat in discussing the original intention of the parties.

After discussing the foregoing lease negotiations and still proceeding in narrative chronological order, the Court next makes findings concerning the estimates of costs of improvements [R. p. 29], and the fact that in June bids were solicited and in July a contract was made for the construction of the building. [R. p. 30.] The Tax Court then made findings [R. p. 30] concerning the payments by the incorporators to petitioner and after pointing out that the payments made in November were agreed upon in November, the Court stated as a portion of its formal Findings of Fact that "at the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof and notes for the remainder. No receipts were given by petitioner for the advances." [R. p. 30.] Immediately thereafter in its narrative findings, the Court states the use to which this money was put. [R. pp. 30 and 31.]

Apparently respondent expects that all of the formal findings of the Tax Court must be recited on each and every occasion petitioner desires to point out to this Court that the trial court found a particular fact to be true. Petitioner, on the other hand, does not see how its failure to touch on Simon's negotiations for a lease in connection with its reference to and reliance upon the finding concerning the original intention of the parties can possibly place upon the quoted sentence a meaning different from that which the sentence itself evidences. Nor does petitioner see how its failure to mention the fact that monies were used for the costs of preparing plans and specifica-

tions and for the building and for building costs, and so forth can possibly alter the meaning of the Tax Court's language that "at the time the advances prior to November were made the individuals intended that stock would be issued for one-half thereof and notes for the remainder."

In discussing these formal Findings of Fact, to which he diffidently refers as "reciting the facts" (Resp. Br. p. 22) respondent avers that "the Tax Court stated what is conceded by all, namely, that the incorporators intended to take half their investment in the *form* of notes and half in the *form* of stock" (italics ours). The truth of the matter is that nowhere in the entire formal Findings of Fact does the Tax Court use the word "form," or the phrase "form of notes" or "form of stock." If, in its formal Findings of Fact, the Tax Court meant to find that the original intention was not to make advances totalling \$30,000.00 for stock and loans on an equal basis, but was to contribute \$30,000.00 to capital while pretending to loan one-half thereof, the Court did so in a manner both curious and ambiguous. Petitioner is not prepared to join respondent in reading into the formal Findings of Fact words which the Tax Court did not itself see fit to furnish.

Apart from respondent's attack upon petitioner's treatment of the record, respondent's position, as revealed by his brief, is elusive and difficult to pin down. It is a curious thing that although respondent's claim against the petitioner for additional income taxes has progressed through the administrative stages of respondent's office, through a trial in the Tax Court and after that trial and the Findings of Fact and Opinion and Judgment to a stage in the appeal beyond the filing of respondent's

brief, petitioner still remains uninformed as to the precise reason for respondent's refusal to treat a portion of the advances to petitioner by its incorporators as an indebtedness. This refusal might stem from either of two contentions of respondent: First, that the notes received by said incorporators were mere pieces of paper, never intended to have legal effect, or second, that although petitioner was genuinely obligated to the individuals over and above the obligation of a corporation to the owners of its stock, such genuine non-stock obligation is so hedged with attributes of a corporation-stockholder relationship that it may not be treated as an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. Either of the foregoing alternatives might be covered by the general statement used both by the Tax Court [R. p. 40] and respondent (Resp. Br. p. 16) that in tax matters the concern is with substance and reality and not with form. And either might be covered by the statement, also used by the Tax Court [R. p. 39] and by the respondent (Resp. Br. p. 20) that a bona fide creditor relationship did not exist.

In his argument, respondent confuses a discussion of sham transactions with a discussion of the hybrid obligation types of cases. Thus, at page 17 (Resp. Br.) respondent cites *Green Bay & W. R. Co. v. Commissioner*, 147 F. 2d 585, 587 (C. C. A. 7th, 1945), a case where the Court had to decide whether debentures, the terms of which failed to provide for a fixed maturity date, and provided for non-cumulative dividends payable only in the discretion of the board of directors, constituted an indebtedness within the meaning of Section 23(b). No question was there involved as to the genuineness of the debenture instruments or as to the rights of the holders of those instruments to enforce the rights actually given

them under the terms thereof. The question was simply one of classification.

On the same page (Resp. Br. p. 17), respondent cites *Commissioner v. Schmoll Fils Associated*, 110 F. 2d 611 (C. C. A. 2d, 1940). That too, was a case where the genuineness of the instrument was not in question. The Court was simply concerned with the problem of whether or not the instrument, called a debenture, more nearly resembled preferred stock than an indebtedness in view of the provisions of the instrument itself. There the instrument provided that so-called interest should be paid exclusively from profits, that the debentures be subordinated to the rights of bank creditors and the instrument provided no maturity date at which the principal amount stated therein was to be paid. A similar type of case is *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F. 2d 182 (C. C. A. 7th, 1942), cited by respondent. (Resp. Br. p. 18.)

In the instant case, however, the instrument evidencing the indebtedness is a negotiable promissory note in ordinary form. If those notes are genuine, there cannot possibly be any problem of classification. True it is in this case that between April 1941 and November 1941, the indebtedness which existed was not evidenced by a promissory note and neither the rate of interest, the maturity date, nor other provisions of the terms of the loan had been determined. If interest paid pursuant to such loans were here involved, petitioner submits that in the absence of contract the law of the State of California would impose the omitted terms and the loan would be repayable upon demand, interest would be paid at the legal rate (Cal. Civil Code, Section 1914).^{*} However, even if the

^{*}See Appendix.

loan, as it existed in this case between May and November, 1941, was deemed to be an obligation which, though genuine, was lacking in all the necessary ingredients of "indebtedness," the conversion of that obligation into promissory notes duly issued in November, 1941, would still require the conclusion that the obligations of the promissory notes were genuine indebtedness. See *John Kelly Co. v. Commissioner*, 326 U. S. 521, 90 L. Ed. 279 (1946); *Toledo Blade Company*, 11 T. C. No. 128 (1948), C. C. H. Dec. 16,736; *Cleveland Adolph Mayer Realty Corp.*, 6 T. C. 730 (1946), rev. in part on other grounds 160 F. 2d 1012 (C. C. A. 6th, 1947); *Clyde Bacon, Inc.*, 4 T. C. 1107 (1945), where in each case the obligation or instrument which was converted into an indebtedness was so converted in consideration of the cancellation of what was clearly and expressly a stock obligation.

It follows, therefore, that the single issue presented in the case can be answered only by determining whether the promissory notes issued by petitioner were genuine or were sham. In looking to the arguments raised by respondent, petitioner proposes to do so only to the extent that they tend to derogate from or support the genuineness of the promissory notes.

Respondent's first point seems to be that the promissory notes were issued to the creditors in direct proportion to their stock holdings. (Resp. Br. p. 15.) As a result, respondent points out that the stockholders are in a position at will to apportion monies paid to the company between stock and indebtedness. Moreover, respondent maintains that the ability to do this was in fact utilized because the plan finally adopted of the division between stock and notes was not in accordance with the original plan (Resp. Br. p. 16.) But respondent does not explain why the ability to change and the fact that pur-

suant to that ability the creditor-stockholders did change the ratio did support a conclusion that the change was not really a change and that the notes were not genuine. In *John Kelly Co. v. Commissioner*, *supra*, the stockholders converted to become stockholder-creditors and the genuineness of the debentures there issued were never questioned. That is also true of the *Cleveland Adolph Mayer* case, *supra*, and the *Clyde Bacon* case, *supra*. True, in the *Toledo Blade Company* case, *supra*, the Commissioner contended that the issuance of debentures in exchange for shares of stock was merely a sham transaction but the Tax Court gave short shrift to that contention merely by looking to the debentures themselves, undisturbed by the fact that there was a single stockholder, stating at page 2420 (C. C. H. Dec. 16,736) that:

“Whatever may be said of the reasons underlying the transaction there can be no question but that the debentures themselves were genuine and evidenced legal obligations of the petitioner. Under their terms the debentures were absolute as to the payment of both principal and interest. Had they been issued to a non-proprietary purchaser for value there could have been no question as to their genuineness. The fact that they were issued to the petitioner’s sole stockholder in exchange for a portion of the interest represented by its stockholdings in the petitioner does not affect their validity.”

Respondent’s next point seems to be the fact that because the entire \$55,000.00 advanced was necessary to place the restaurant in condition to commence business, it was reasonable for the Court to conclude that the entire funds supplied by the incorporators were subject to the hazards of the business and part of its capital structure. (Resp. Br. p. 17.) Later, on page 20 of his brief, re-

spondent makes a similar point, quoting from *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F. 2d 182 (C. C. A. 7th, 1942), at page 186, to the effect that "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation payable in any event." Respondent's error lies in his misconception of the nature of the risk involved. The risk which distinguishes stock from indebtedness and to which the *Meridian & Thirteenth Realty Co.* case referred relates to the different legal rights given to stockholders on the one hand and creditors on the other. Certainly stockholders do not have an obligation from their corporation which is payable in any event whereas creditors do have such an obligation from their debtors. The obligation to be repaid in any event did exist in favor of the creditors here and as the Court found [R. pp. 28-29], was one of the very reasons the creditor-stockholders chose to contract with petitioner in the manner in which they did. The only risk to which the amounts advanced to the corporation here as loans were subject were economic risks. In that sense, it is true that the entire amount was subject to the hazards of the business. This would have been true whether the monies were borrowed from the incorporators or from the bank. When monies are borrowed they are commingled with the borrower's other funds and normally are not set apart by the borrower as a trust fund. The borrower presumably uses the funds in his business and if the assets acquired with the borrower's own funds and the borrowed funds become consumed without replacement, a deficit is created and the borrower becomes insolvent. Almost every bankruptcy case is an illustration of how creditors' funds are placed at the risk of the business.

The case of *Maloney v. Spencer*, 49-1 U. S. T. C., ¶9176, Dec. Feb. 11, 1949 (C. A. 9th), is an excellent example of a case where a lender, who also happened to be the sole stockholder of two companies which became insolvent, found that the loans which he had made were placed at the risks of the business. If this fact tended to support a conclusion that a loan evidenced by a promissory note is not genuine, no loan which is unsecured can be said to be a genuine loan and that, of course, is obviously absurd. The case of *Green Bay & W. R. Co. v. Commissioner*, 147 F. 2d 585 (C. C. A. 7th, 1945), cited by respondent as support for his reasoning in this regard was the case in which the genuineness of the debenture bonds therein issued was not in question but the problem was one of classification. Because of other facts, as well as the fact that these debenture bonds were subordinated to other general creditors and were, therefore, placed at *greater* risk than ordinary loans, the Court concluded that the debentures were more akin to capital stock than to indebtedness. If the promissory notes here involved had been placed at greater risk than the obligations to **general** creditors, that factor might have weight to support a conclusion that they were not genuine, although even such a subordination was considered compatible with genuine indebtedness in *Commissioner v. O. P. P. Holding Corp.*, 76 F. 2d 11 (C. C. A. 2d, 1935). However, in this case there was no desire to have these notes placed at greater risk than the obligations owing other creditors. On the contrary, the Court expressly found that "the individuals desired to be in a position to participate with general creditors for part of their investment in the event petitioner's business was not successful." [R. p. 28.]

Respondent next points out that no interest was ever paid or accrued between May and November, 1941, as well

as the fact that the maturity date, rate of interest and the amount of the indebtedness were not fixed as the advances were made. Petitioner has amply discussed these points in its opening brief (pp. 29-37) and mentions the point here merely for the purpose of continuity.

In the next paragraph of his brief (p. 17), respondent, in one breath and one paragraph seems to be making several points. In his first sentence he discusses the scope of review. This matter has been amply covered by petitioner in its opening brief (pp. 43-47). He next makes the point that "apart from the testimony of the incorporators to the effect that they intended that part of their investment to be taken in the form of loans, and the fact that 'promissory notes' were issued, there is little in the record to support the contention that a bona fide creditor relationship existed." Petitioner is at a loss to understand what more respondent requires in the way of evidence. There were, after all, only a limited number of advances and notes. In effect, respondent asserts that the Tax Court was justified in asserting that the petitioner's incorporators were perjuring themselves simply because they did nothing more than testify as to their intent [R. pp. 65-66, 138] produce the notes [Pet. Ex. 19, 20, 21] produce the minutes of the corporation [Pet. Ex. 12], produce the application for the issuance of a stock permit dated July 14, 1941 [Ex. 4-D, R. p. 298] wherein they announced, under oath, their intention to have the corporation borrow money from the incorporators and adduced the testimony of their attorney. [R. pp. 250-251.]

The next point made by respondent (Resp. Br. p. 17) and in the same paragraph, is the fact that originally the taxpayer's books did not reflect any promissory notes

or indebtedness to the taxpayer's incorporators. Petitioner has amply covered this subject in its opening brief. (Pet. Br. pp. 39-42.)

Respondent makes a similar point (Resp. Br. p. 18) with respect to the balance sheet included in the income tax return for the year 1941. While it is true that this return was signed by petitioner's president, it is also true, as respondent's witness, Whittaker, testified [R. p. 110] that petitioner's president did not read the return. Since the question of the incorporators' intent relates to their state of mind, the failure to show the indebtedness upon the balance sheet contained in the return cannot be said to be inconsistent with Carpenter's state of mind where Carpenter was actually ignorant of this failure.

Respondent's next new point (Resp. Br. p. 19) relates to the requirement of a maturity date for an indebtedness. Petitioner concedes that an essential attribute of a creditor's obligation is a fixed or determinable date for the payment of the obligation. But in this case, if the notes were genuine, there was a fixed maturity date fixed at two years from the date of the note. Petitioner submits that the test of genuineness is not the date of actual payment. A creditor might in advance intimate his intent to be fair or lenient under proper circumstances but that alone would have no bearing upon his rights. The nature of the obligation is determined by what its holder has a right to do and not what he may choose to do under given circumstances.

Respondent's next point concerns the creditor's so-called laxity in enforcing their rights and protecting their investment. (Resp. Br. p. 19.) From this alleged laxity, respondent draws the conclusion that it was never intended

to assert the right to demand from the corporation a fixed amount on a fixed date in payment of the obligation but rather that it was intended to recover this portion of the capital investment when and if the fortunes of the business warranted. It is easy to submit that this is "the only reasonable conclusion" because to a large extent reasonableness is a matter of opinion. Actually in this case, we find and the Court held [R. pp. 28 and 29] that the incorporators wished to be in a position to demand payment of their loans after a limited period even if the corporation did not have a profit. Therefore, at the outset, they were concerned with their *right* to demand repayment and in November of 1941 fixed the two year period as maturity date. It is far more reasonable to assume that at the end of the two years they acted in the light of the facts as they existed at that time rather than to assume that at the outset they did not intend to have the *right* to demand payment at the maturity date. Respondent speaks as if banks never renew instruments after maturity; yet if petitioner here had issued renewal notes at the end of the two years, it is reasonable to suggest, in view of the tenor of respondent's brief, that respondent would have dismissed this act as a mere formalistic gesture. Actually, since the notes were far from outlawed at the time they were ultimately repaid, the holders' acts in failing to demand renewal notes from the corporation which they controlled does not reflect their intent at the time they made the advances or at the time of the issuance of the notes.

Nor does the fact that the incorporators hoped and expected that there would be profits in the business detract from their intention to make loans. In the recent case of *Maloney v. Spencer*, 49-1 U. S. T. C. 9176, decided Feb. 11, 1949 (C. A. 9th) the taxpayer caused to be incorporated three corporations, in which he owned all of the stock other than the qualifying shares. The taxpayer paid no cash for his stock but transferred contracts to the companies in exchange for the stock. Although he attempted to obtain outside loans for the financing of the corporation's activities, these attempts were unsuccessful and as a result he was required to advance considerable sums to his corporations continuous over a period of three years. The opinion in the case does not reveal any demands by the taxpayer upon the corporation for repayment of these advances. In holding that the advances constituted loans and not capital contributions, the Court pointed out that

“the liabilities were agreed to be incurred by taxpayer in the expectancy that the corporations would be successful in business and pay off the obligations to him. . . .”

There, in spite of the fact that the taxpayer did not make demands or sue his corporations for recovery of the amounts advanced, the Court did not think that the only reasonable conclusion to be drawn from the taxpayer's failure to do so was that it was never intended by the taxpayer to assert the right to demand repayment of the fixed amounts at a fixed time. Nor did the Court think it fatal that the creditor stockholder there hoped and expected that

the corporations would make substantial profits and thereby be enabled to repay the advances.

On page 21 of his brief, respondent suggests that “apparently it is taxpayer’s position that the holders of the ‘notes’ may treat themselves as creditors for taxation purposes but conduct themselves as stockholders in regard to the alleged ‘loan’.” Obviously that is not petitioner’s position. Petitioner simply maintains that incorporators have a right, if they choose, to lend money to their corporation, even though in direct proportion to their stock holdings. That a tax advantage from such a situation may result does not derogate from that right any more than the fact that other legal advantages may result. Some of such other legal advantages were the right to share with other general creditors in the event of failure mentioned by the Court [R. pp. 28-29], the right to receive repayment of the loans unrestricted by California Corporation Code, Section 824* or the right of any given minority stockholder to receive repayment unrestricted by the will of his majority co-stockholders. It is petitioner’s position that when a Court views the subsequent actions of such a creditor stockholder for the purpose of determining what went on in his mind at a prior date, the Court cannot properly weigh those actions for that purpose if it disregards the fact that the creditor who also has a proprietary interest will fail to be on the court house steps with a Writ of Attachment on the day following maturity.

*See Appendix.

In summary, respondent's brief does nothing to strengthen the weaknesses in the Tax Court's opinion which petitioner has heretofore discussed in its opening brief. The conclusion of the Tax Court still remains erroneous and its decision should therefore be reversed and judgment entered in favor of the petitioner.

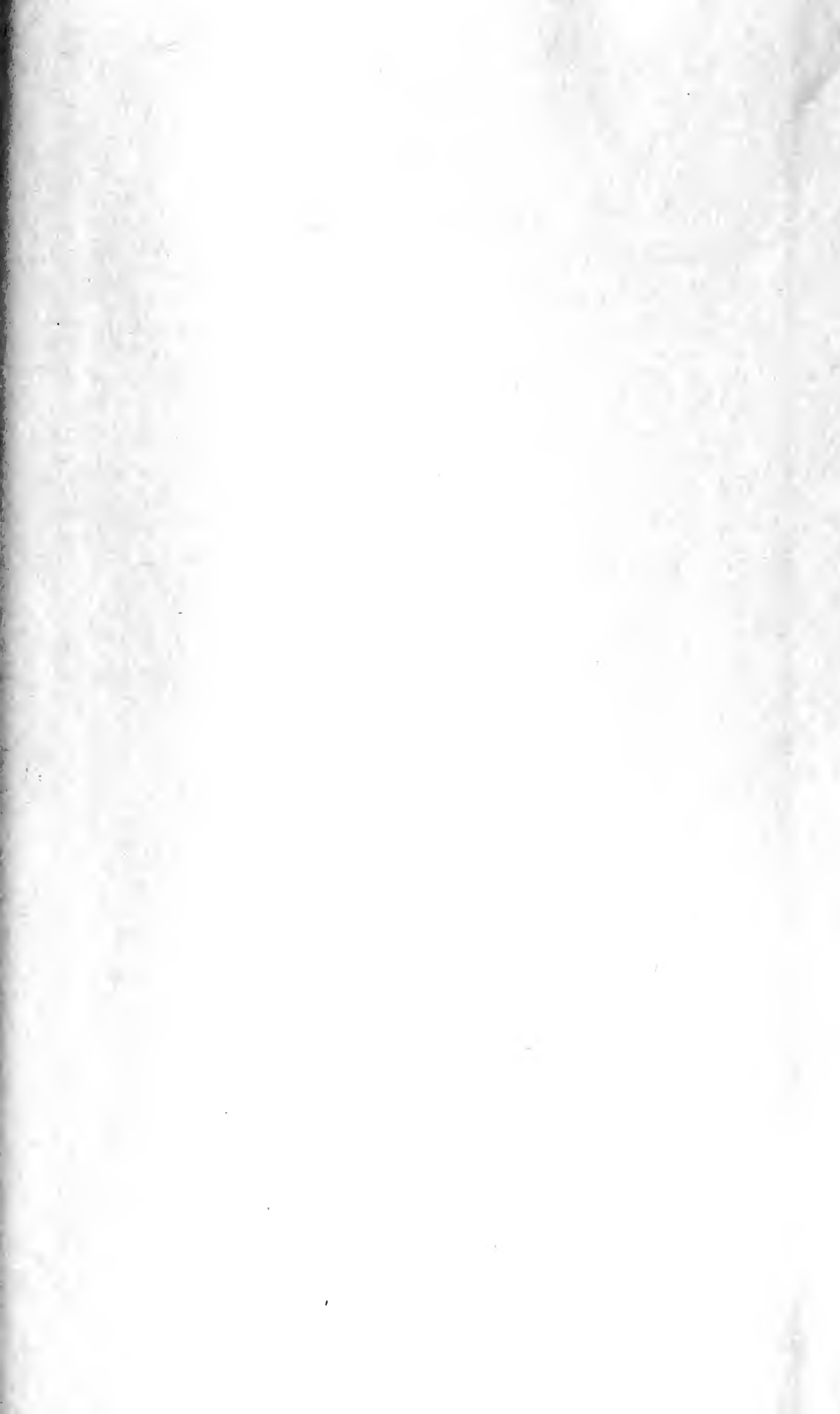
Respectfully submitted,

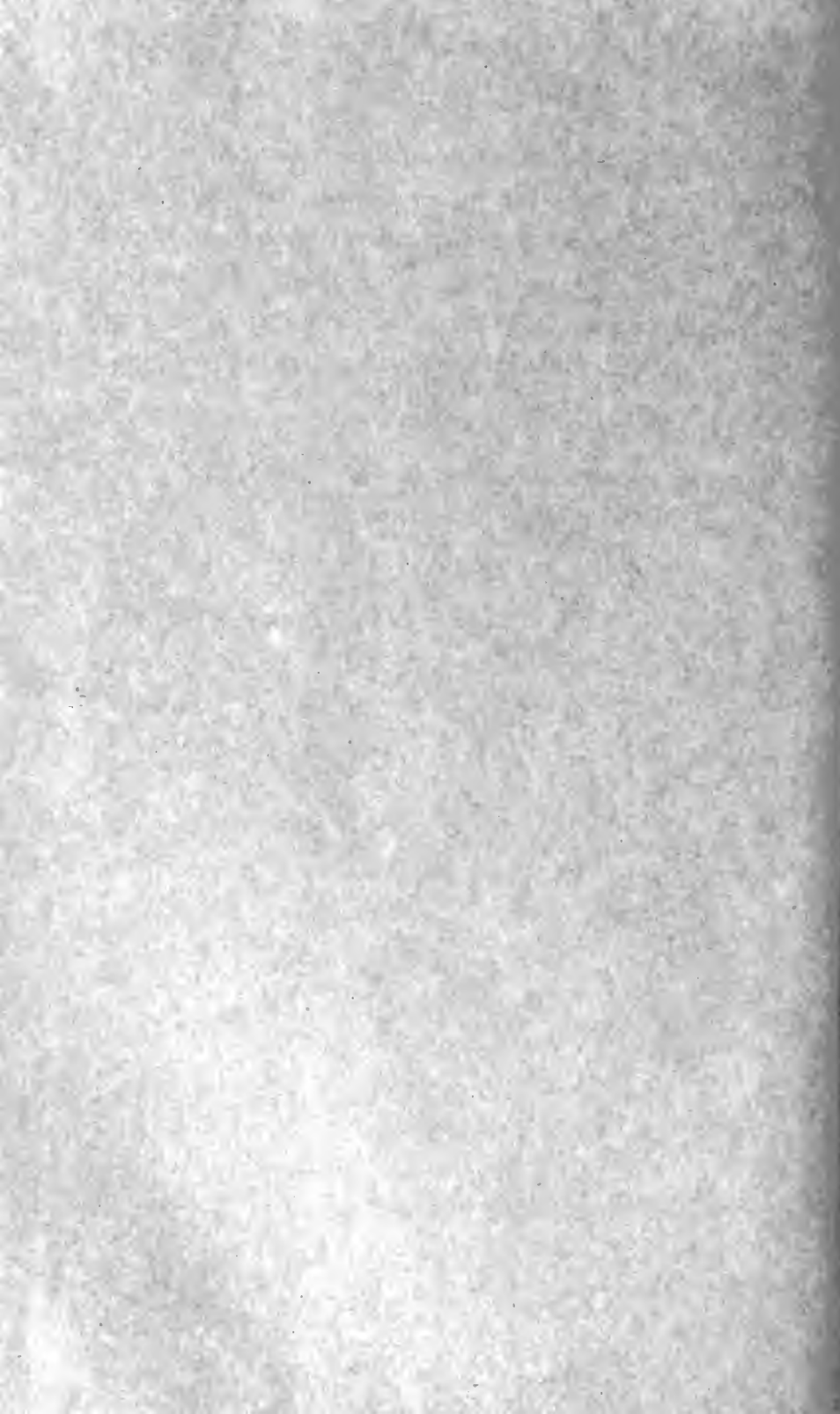
SWARTS, TANNENBAUM, ZIFFREN &
STEINBERG and JACOB SHEARER,

Attorneys for Petitioner.

DAVID TANNENBAUM,
JACOB SHEARER,
MITCHELL AARONSON,

Of Counsel.





APPENDIX.

CIVIL CODE OF CALIFORNIA, SEC. 1914. INTEREST ON LOAN. Whenever a loan of money is made, it is presumed to be made upon interest, unless it is otherwise expressly stipulated at the time in writing.

CALIFORNIA CORPORATIONS CODE, SEC. 824. UNLAWFUL PURCHASE OF SHARES, DECLARATION OF PAYMENT OF DIVIDENDS, OR WITHDRAWAL OR DISTRIBUTION OF ASSETS. Except as provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

